

Selected Issues in South Carolina's Tax and Education System

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Executive Summary

This report addresses three issues: the South Carolina tax structure and previous research commissioned by the Palmetto Institute on its characteristics, the effects of Act 388 and related tax and policy changes, and the effects of a recession on tax revenues in South Carolina. This summary reviews the basic findings and conclusions of each section.

Evaluating and Reforming South Carolina's Tax Structure

The Palmetto Institute sponsored research on the South Carolina tax system during 2005 and 2006 and the result is a series of working papers that are comprehensive, well done, and summarized and synthesized in Ulbrich (2005a). Overall, the papers are good summaries of the South Carolina fiscal structure. Conclusions reached in the earlier papers are qualitatively consistent with those found in this report and provide a basis for designing appropriate reforms in the structure. Among the conclusions reached in this report and the earlier research are:

- Tax policy choices should be made based on consideration of the state and local system as an integrated structure.
- South Carolina needs both an adequate revenue system and sound budgetary practices. Off-budget funds, financing with nonrecurring revenues and earmarking are some approaches that create instability and inflexibility in the budget system.
- Most major South Carolina tax reforms have been based on independent, research-based analysis performed by outside agencies appointed by the General Assembly, with other major interest groups generally involved in the analysis and discussions.
- Overall, revenues have grown at about the same rate as the economy, with local revenues rising faster than state revenues. Expected economic trends, demographic patterns and policy changes will slow South Carolina's long-term revenue growth.
- South Carolina revenue growth is volatile across the business cycle, though not more so than the national norm. The tax system should be designed to limit the volatility, but mechanisms, such as rainy day funds, should be used to smooth out expenditure patterns.
- The burden of South Carolina's state and local tax structure is low relative to other states. However, although the corporate income tax rate is relatively low, the overall business tax burden is not as low relative to the nation as is the individual structure. Property and sales taxes on input purchases are the largest business taxes.
- South Carolina's reliance on various revenue sources is similar to that used by most states, although some differences exist.
- Considerable political pressure has existed for changes in the property tax system, as evidenced by Act 388 and a series of other changes. While burdens are not high on average, the distribution of the burden has shifted considerably over time both because of policy choices and relative growth rates of property values, and this has sparked structural adjustments.

Based on the research, the Palmetto Institute's challenge is to design and advocate a reformed tax structure that achieves the Institute's intended goal, a more competitive South Carolina economy. The next step must be development of a detailed reform agenda that will result in a more competitive tax system for South Carolina. Other criteria for a good tax system, including adequacy, minimal economic effects, low administration and compliance burdens, and fairness, must be considered as the competitive tax system is designed; indeed, these criteria have implications for a competitive tax system. Then, the Institute must begin selling the plan. The best approach is to involve other interest groups in designing the plan so there are other natural advocates for the reform. Then, the Palmetto Institute and the other advocates can work to get buy-in and implementation from the General Assembly.

The following guidelines provide an initial framework for a competitive tax system. First, the structure must generate adequate revenues, both now and going forward, to allow South Carolina to invest in itself. The state must invest in its labor force through quality lifetime learning, K-12 education and higher education to compete with the rest of the world. Without these investments, the state's per-capita income and other measures of a competitive economy are likely to slowly decline relative to the U.S. South Carolina also must have the resources to invest in appropriate state of the art infrastructure to compete in the global environment. This guideline means that South Carolina should not see a "discount" tax structure and economy as its goal, but instead should ensure that appropriate revenues are generated for these essential investments. But it also means that taxes cannot and should not be too high.

Second, the state should seek broad tax bases and low rates. This does not imply that taxes should be imposed without careful thought about what belongs in the base. It means that tax concessions and other base erosion granted to reap short-term political gains must be kept to a minimum to allow the necessary revenues to be generated with low rates. Narrow bases are likely to lead to excessively high tax rates. Restrictions, such as Act 388, make it difficult to achieve the first two general guidelines.

Third, the tax system should be used sparingly to engineer the economy. Taxes on "social bads," such as alcohol and cigarettes, have an appropriate place in government finance. But tax concessions more generally are unlikely to enhance South Carolina's economy and are more likely to erode the tax base and result in higher marginal tax rates. Targeted

tax concessions may be necessary in some cases, but should be the exception since South Carolina governments will not be as good at picking which firms and industries are likely to succeed as is the private economy. Similarly, significant efforts to alter the redistribution of income are generally inconsistent with broad tax bases and low tax rates. The national tax structure and targeted expenditures are better tools for achieving desired income redistributions.

Fourth, businesses should pay taxes because they benefit from public services. Increased business tax burdens should not be seen as a way to lessen the burden on individuals to achieve short-term political gains. Raising business taxes increases operating costs in South Carolina and makes the state a less attractive place to start, expand and locate economic activity. Growing economic mobility makes tax differentials increasingly important to such business production decisions. Similar arguments hold with respect to tourism and related activity. Tourists should pay for the services they receive, but should not be seen as a means to extract significant payments to subsidize services for residents.

Finally, South Carolina should change the tax system infrequently. Any appropriate reforms should be identified and implemented and then the tax structure should be left alone while the state focuses on running good government and investing in itself. The business community prefers certainty about tax liabilities, which is inconsistent with frequent policy changes. Further, it is politically difficult to make changes in the tax system unless they erode the tax base.

Before adopting any significant changes in the state and local tax system, South Carolina should ensure that the proposed changes are studied carefully and objectively so that their potential impacts on taxpayers and the state's economy are well understood. Many of the consequences of Act 388 discussed in this report could have been identified in advance and made part of the public discussion, quite possibly leading to more-informed public decision-making. One way to accomplish this is to establish a permanent tax-study commission with responsibilities to conduct a periodic comprehensive study of the tax system and to analyze and report on significant proposed changes in the tax system.

Act 388 and Other Policy Changes

In 2006 South Carolina restructured its property tax through legislation and a constitutional amendment that, in combination, (1) eliminated the property tax on owner-occupied housing for school operating expenses, replacing it with a one percentage point

increase in the statewide sales tax (other than on unprepared food), (2) eliminated the sales tax on unprepared food, (3) required the state to reimburse school districts on a dollar-for-dollar basis this year and using a formula in subsequent years, (4) established a cap on property tax millage increases for operating purposes, for each individual local government, equal to the percentage increase in the Consumer Price Index plus the percentage increase in population for the local government, and (5) imposed a 15 percent cap on increases in property tax assessments over 5-year periods, except when property is transferred.

Effects on State Finance

One issue is how state government finance is affected by the new structure. The one percent sales tax rate increase should be sufficient over the long term to finance the replacement revenue for the property tax that was eliminated on owner occupied housing. Sales tax revenues should rise faster than the combination of CPI plus population growth in the average year, though it is probable that revenue growth will be insufficient during recession years. For example, in 2002 sales tax revenues would have fallen \$50 million short of the required revenue under the swap if it had existed. The overall package of reforms reduces state tax revenues. Elimination of the sales tax on food will reduce state government revenues by approximately \$336 million, part of which is a loss to the general fund and the remainder is a loss to the Education Improvement Act Fund.

The swap increased South Carolina's reliance on the relatively volatile sales tax. However, the swap only amounts to about 4 percent of state tax revenue and sales tax revenue growth is fairly highly correlated with other tax revenue growth. Simulations based on historical tax performance suggest that the change has essentially no effect on state tax revenue growth, or on volatility of the overall tax structure.

Effects on Local Finance

Simulations based on reasonable assumptions indicate that the swap and other policy changes will reduce the growth rate of school district spending. If we presume that school districts statewide seek to increase spending at rates consistent with recent history, here assumed to be 1.3 percentage points above population plus CPI growth, then revenue growth would not be sufficient to fund desired spending. School district revenue growth is likely to be about 0.6 percent above population and CPI growth, which means that after 10 years revenue would fall 6.5 percent short of desired spending. The constraint may be

precisely what South Carolina voters and legislators intended, but accomplishing it will require a sharp break from past revenue raising and expenditure practices. Furthermore, some desire for spending increases at the local level will be driven by state mandates, placing additional pressure on school districts.

School districts in rapidly growing areas will have the greatest growth in their assessed value tax bases and their capacity to fund increases in spending beyond population growth plus the CPI. However, some of these counties have also had rapid growth in desired spending, and will have to scale back spending growth to live within the millage cap.

Growth in the property tax reimbursement pot, based on population and CPI, is distributed across districts based on the share of total weighted pupils. This approach disadvantages fast growing districts. The formula effectively lowers the per pupil transfers to fast growing school districts and raises them to slow growing school districts. The constraints on local revenue have left the fast growing districts with few options for financing the growth.

Act 388 and the related legislation do not appear to have been fully integrated with other existing statutes. For example, the Index of Taxpaying Ability, which is used to determine the local share of costs under the Education Finance Act, was not adjusted to account for elimination of the homeowner tax for schools. This appears to hurt areas with high shares of residential property, such as Lexington County, relative to those with low shares, such as Fairfield and Allendale Counties.

An additional point from the local perspective is whether their new revenue source -- reimbursements -- is more reliable than their old revenue source, property taxes. And the answer there is a decided no. If the state suffers a significant shortfall in sales tax revenue, there is a good likelihood that other revenue sources -- particularly the income tax -- will suffer as well, and South Carolina will face difficult budget decisions. Under those circumstances it would not be surprising for the state government to scrutinize reimbursements and consider cutting them by passing new legislation reducing transfers to school districts.

Other Effects

The swap of sales for property taxes affects different taxpayers very differently.

Homeowners received a property tax reduction and will benefit from the exemption of unprepared food from the sales tax, but must pay the higher sales tax rate. The net effect is that almost all homeowners will receive a tax cut. Renters received no property tax cut, but pay the higher sales tax rate and benefit from exemption of food from the sales tax. Thus, total tax liabilities for renters will increase unless their savings from the food exemption are larger than the cost of the higher sales tax rate. In general, only lower income renters who do not use significant food stamps (which were already exempt from sales tax) should see a sales tax reduction.

Businesses will pay higher taxes. They are subject to the higher sales tax rate on taxable business input purchases and save essentially nothing from the exemption of food. Estimates are that business input purchases represent slightly over one-half of the sales tax base. As a result, business taxes will be about \$250 million higher in 2008 because of the sales tax rate increase. Thus, the business share of local education costs has risen by about four percent. Business tax burdens will rise over time with their input purchases and with an increasing millage rate (which is limited to the increase in population plus the inflation rate).

Assessment caps can also create a “winners who lose” effect. An assessment-increase cap, by itself, will not lower property taxes. What it does is lower property taxes for some property owners at the expense of others, and these effects occur within and not across counties. Indeed, some properties ostensibly benefiting from the assessment cap will pay more than they would in absence of the cap. The effects depend on such factors as how long people hold their houses and how rapidly property values are rising.

The property tax cap creates a series of economic distortions. For example, property owners suffer from a lock in effect because the growth in assessed value is limited until the property is sold. The result is the tax burden rises, potentially significantly, when property is sold discouraging property transfers. Businesses, homes, and other property should change hands less often as a result. Research in other states indicates that the holding period for property has risen by six percent or more as a result of similar limitations.

South Carolina Revenues and Recession

Recessions do not occur simply because the time has come. The undoing of imbalances or excesses in the economy and exogenous shocks often trigger recessions. Many

indicators suggest that the U.S. economy is now in a recession or soon may be. The unwinding of the subprime mortgage lending excess is constraining credit, reducing asset values and the ability to spend, and shaking consumer and business confidence. Record high oil prices are constraining the ability of consumers to spend in other areas of the economy. The declining stock market may cause consumer spending to slow further. All of these changes have increased the odds of recession. Many forecasters now believe the U.S. economy is in a recession.

Still, the economy's overall volatility is diminishing, resulting in what Federal Reserve Board Chairman Ben Bernanke has called the "Great Moderation." This is good news from an economic growth perspective, but does not necessarily translate into lower tax revenue volatility. For example, the very mild 2001 recession precipitated the greatest revenue slowdown in at least 50 years.

The causes of recessions, and therefore how the recession effects are distributed, vary across states. During the last three recessions South Carolina has performed worse than the nation for a substantial part of each recession. However during the past two recessions, two years after the recessions' beginning, South Carolina's recovery was actually stronger than the U.S. recovery. Tourism, while an important component of South Carolina's economy, is not the cause of South Carolina's recession sensitivity. Employment in leisure and hospitality declined slightly before resuming its rise during the last two recessions and declined by far less than employment in goods-producing and trade and transportation industries.

Similarly, the response of state tax revenue depends on the state tax structure, the type of recession and other factors, so no simple relationship exists between economic performance and tax revenues across the business cycles. Precisely how revenue will be affected depends upon the structure of taxes and on the characteristics of the recession. There is no clear answer about which tax is most susceptible to recessions. In some circumstances income taxes can be hit harder than sales taxes while in other circumstances the opposite is true. States that rely on a portfolio of different taxes are likely to have less volatility than states that rely heavily on a single tax. Revenue from individual taxes generally does not move in lockstep with revenue from other taxes, and so much as a portfolio of different securities will be less volatile than individual securities, a portfolio of taxes also will be less volatile than a single tax.

South Carolina's revenue performed worse than the national average in the 1990 recession but very similarly to the nation in the 1980 and 2001 recessions. Revenue declined far more sharply in the 2001 recession than it did in the earlier recessions, which seems at odds with analysis showing that the most recent recession was in fact less severe. In fact, state government nominal tax revenue for the 50 states as a whole declined for two consecutive years during this period, the first time in at least 50 years that this has occurred.

One reason the income tax fell so sharply in South Carolina and in other states in the 2001 recession is that capital gains, which had grown enormously prior to the recession, fell sharply as stock markets plummeted. It is clear that gains are far more volatile than other income and contributed to the decline in South Carolina's income tax in the 2001 recession. The current economic slowdown, caused heavily by the housing bust, is likely to weaken the sales tax relatively more than the income tax.

Evaluating and Reforming South Carolina's Tax Structure

State tax and revenue structures are best evaluated as a package rather than as a set of individual revenue instruments. The main reason is that there are portfolio effects within the overall tax structure with the strengths of a tax or fee in one dimension tending to offset weaknesses in another and vice versa. Further, *state* and *local* revenues should often be evaluated together because states grant local governments the authority to raise revenues and state and local governments work together to provide the set of services for which they are jointly responsible. The interdependency of the two levels of government is apparent in South Carolina through the pattern of replacing lower local property tax revenue with additional state transfers.

South Carolina state government raises a slightly larger share of the combined state and local tax revenues than in the average state. South Carolina state government generates 62.0 percent of tax revenues versus 59.1 percent in the average state. The local share of tax revenues has risen rapidly since 1991/92 when the local share was less than 31 percent to about 38 percent today. Much higher growth rates in local taxes compared with state taxes, as described below is the reason.

Criteria for Evaluating Tax Policy

A series of criteria is generally used to evaluate revenue systems. Adequacy, equity, minimal effects on the economy and low administration and compliance costs are common goals for an evaluation. In addition, political acceptability is an important aspect of a good tax system. Adequacy has three components: generating sufficient revenues to finance desired services today, generating sufficient revenues over time, and generating revenues that are not highly cyclical. Revenues are adequate today if they allow state and local governments to deliver the services demanded by South Carolina residents without allowing significant waste. No single measure exists of whether revenues are currently sufficient, though some people will certainly say government is too large and others that it is too small. The common approach is to compare South Carolina's revenue on a per capita basis and as a share of personal income with that raised in other states. The comparisons are useful, but still do not answer whether South Carolina's revenues are sufficient to deliver the public services demanded by South Carolina's citizens since South Carolina residents may have different demands for public services than those in other states.

State and local governments must deliver services not only in the current year but in future years as well. So, a revenue system is only adequate if it expands so that services can continue to be financed over time. The growth over time can be separated into two dimensions: the trend component necessary to meet demands that rise with population and the economy and the business cycle component. Trend growth is best evaluated over long time periods, say at least 10 years.

Cyclical growth is better examined across the downswings and upswings in the economy, and so would be evaluated within a period of about 10 years. The system should not be overly cyclical because services must be provided both in expansion and recession years. All tax systems are cyclical to some degree so this must be evaluated in a relative sense (see Bruce, Fox and Tuttle, 2006, and Boyd, 2007) Also, states generally need other means to allow them to appropriately maintain services over the business cycle, such as reserve funds, because state tax instruments cannot be structured in a way that offsets the revenue volatility to the extent needed.

Fairness is in the eye of the beholder, so no single structure will be seen as fair by all observers. Fairness has two elements: horizontal equity and vertical equity. Horizontal equity refers to how taxpayers with the same ability to pay are treated and vertical equity refers to how taxpayers with different ability to pay are treated. Most people believe that horizontal equity means people with the same ability to pay have the same tax liability. Vertical equity generally means a greater tax liability for those with greater capacity to pay taxes. Taxes are described as progressive, regressive or proportional depending on how fast the liability rises with ability to pay.

Fairness is a difficult concept to apply to businesses because they do not have ability to pay in the same sense that individuals do. Economists normally argue that business taxes should be neutral, which means that taxes should be imposed evenly on the capital used in each industry. Further, the tax burden on business should not be unduly large. Often the latter is taken to mean that businesses should pay taxes according to the benefits they receive from public services. While the notion of benefit taxes is conceptually appealing, it is difficult to implement in practice.

All taxes have the potential to distort behavior, whether it be by discouraging work, saving or investment. Tax structures should be built to limit these effects whenever possible because these distortions cause people to be worse off and can reduce economic

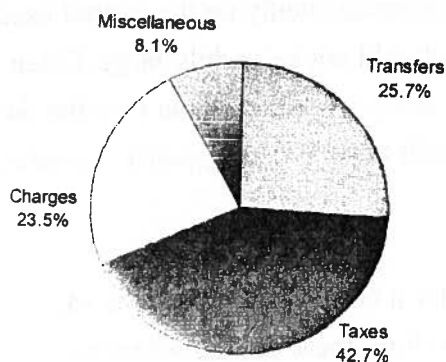
growth. In some cases states may want to use tax structures to reinforce certain policy goals, such as discouraging smoking or excessive alcohol consumption or stimulating economic activity in one sector. But, the use of tax systems to influence behavior must be done judiciously because many decisions, such as most business investment choices, are often better left to the private market economy.

The next part of this report provides a brief review of the South Carolina tax system in light of these criteria. The intent is to provide a baseline for evaluating the previous research on tax structure conducted for the Palmetto Institute.

South Carolina State and Local Government Revenue Sources

This section describes the South Carolina revenue structure and how the tax system fares relative to the criteria described above. South Carolina state and local governments collected \$27.6 billion in Fiscal Year 2005 according to the most recent available data from the U.S. Bureau of the Census, the authoritative source for comparing finances across states. The revenue came from four basic sources (see Figure 1). Taxes provided \$11.8 billion, or 42.7 percent of revenues. Transfers from the federal government were responsible for \$7.1 billion, or 25.7 percent. Charges and fees provided \$6.5 billion or 23.5 percent. Miscellaneous sources, such as interest, sales of assets and others, collected \$2.2 billion or 8.1 percent. This report primarily focuses on tax collections, and to a lesser extent on fees and charges. Federal transfers are often given to further certain federal policy objectives, such as Medicaid, and do not represent funds that South Carolina can easily divert to meet its goals and objectives. Miscellaneous revenues tend to be available for narrow uses and substantial portions may be non-recurring.

FIGURE 1: South Carolina Revenue Sources, 2005



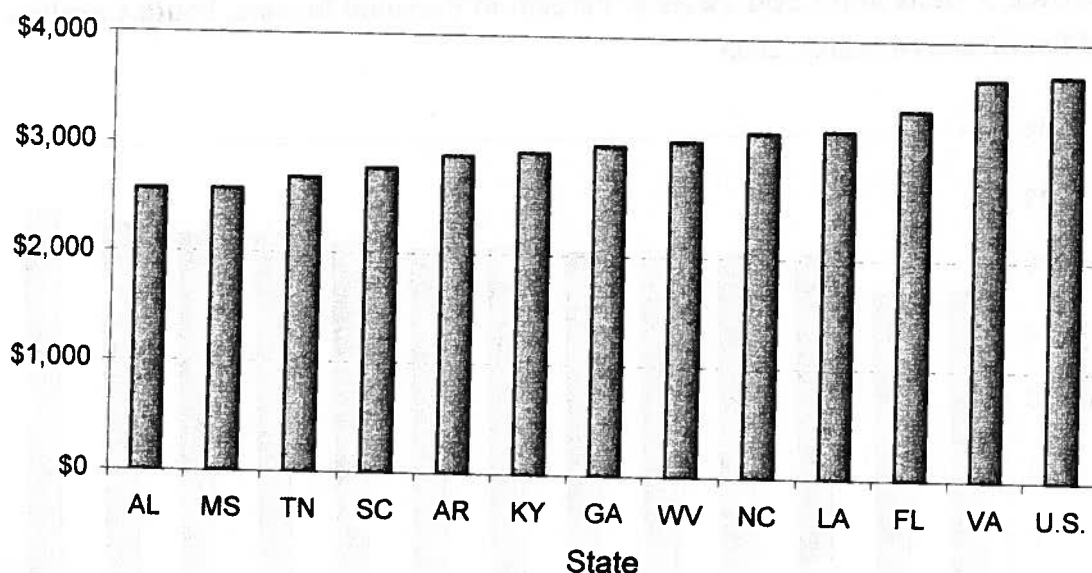
Source: U.S. Bureau of the Census

Adequacy of taxes is often judged by comparing one state's tax revenues with those in other states. South Carolina's state and local taxes are very low based on this standard.¹ South Carolina tax

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revenues were \$2,779 per person in 2005, which is 46th highest among U.S. states.² Taxes in southeastern states are generally low with all states having per capita taxes below the U.S. average (see Figure 2). South Carolina per capita tax revenues are lower than the \$3,149 per person in North Carolina (33rd highest) and \$3,010 in Georgia (38th) and are fourth lowest in the southeast.

FIGURE 2: Per Capita State and Local Taxes, South Carolina and Southeastern States, 2005



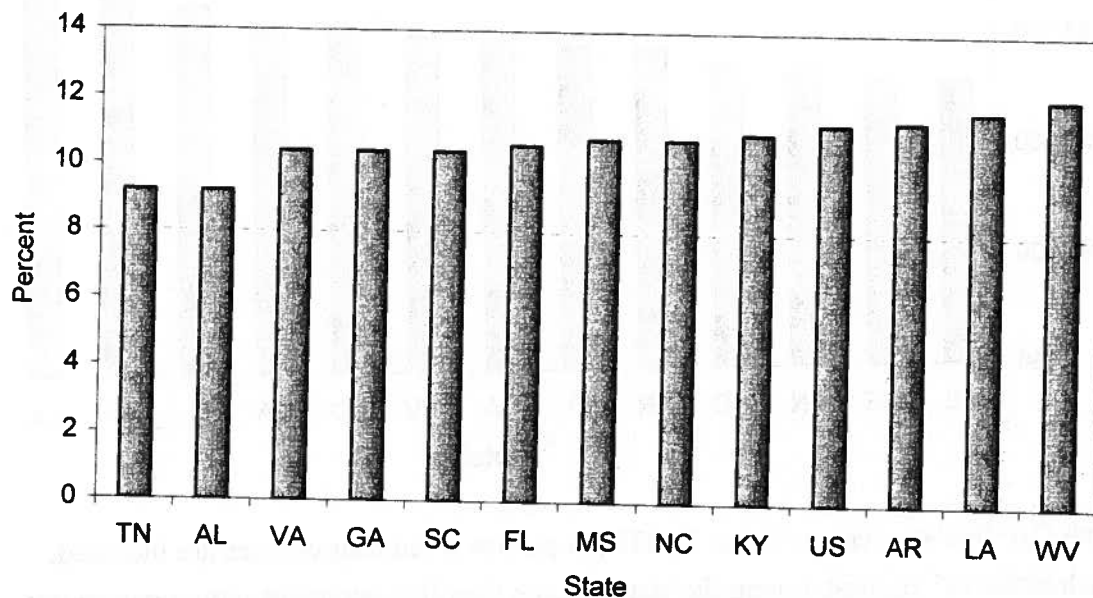
South Carolina's revenues rise to \$4,832 per person when user charges are included, which ranks 34th highest among the states. South Carolina generates more revenue per capita than either Georgia or North Carolina when the user fees are included. Large user fees for both state and local hospitals explain most of the difference, and this is probably attributable to differences in the propensity to have public (as opposed to private) hospitals in South Carolina compared with other states. Further, fees that are used to provide South Carolina's match as part of the Medicaid program likely explains some of the difference. Thus, South Carolina's higher ranking when taxes and fees are added together is the result of structural issues and not evidence of a larger burden being imposed on the state's residents.

South Carolina continues to have taxes significantly below the national average when

² See <http://www.taxadmin.org/fta/rate/05stlrev.html>

measured as a percentage of personal income (see Figure 3). The tax burdens in South Carolina, North Carolina and Georgia are similar as a percentage of personal income.³ Georgia and South Carolina both raise 10.4 percent of personal income in state and local taxes (South Carolina is 39th and Georgia 40th in the U.S.) and North Carolina is slightly higher at 10.8 percent (32nd in the U.S.). South Carolina taxes as a percent of personal income are fourth lowest in the southeast and are well below the national average, which is 11.3 percent of personal income.

FIGURE 3: State and Local Taxes as Percent of Personal Income, South Carolina and Southeastern States, 2005

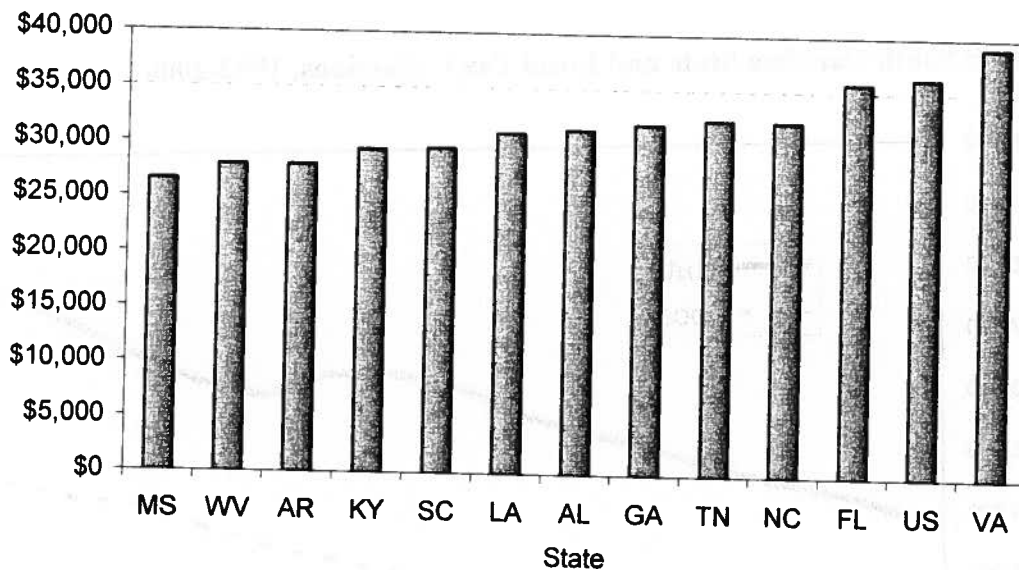


South Carolina per capita personal income was \$29,515 in 2006, up 4.3 percent from 2005. South Carolina's personal income was 45th highest in the U.S. and was well below the \$32,234 in North Carolina and the \$31,891 in Georgia (see Figure 4).⁴ Virginia is the only southeastern state with per capita personal income above the U.S. average.

³ See http://www.taxadmin.org/fta/rate/05stl_pi.html

⁴ See http://www.bea.gov/newsreleases/regional/spi/spi_newsrelease.htm

FIGURE 4: Per Capita Personal Income, South Carolina and Southeastern States, 2006



Tax revenue growth

The long-term adequacy of taxes must be examined in terms of the growth in revenues. Tax revenues in South Carolina have risen a compound annual 5.8 percent since fiscal year 1991/92 (see Figure 5). Growth has been much faster at the local level, where tax revenues have risen 7.5 percent annually, versus only 4.9 percent at the state level. Faster growth in local revenues explains the increasing local share of the combined state and local taxes. The growth rates fail to evidence the full extent of shifts from state to local revenues since some local revenue losses from exempting various properties from the property tax have been replaced with transfers from the state, so that even more of the revenues effectively accrue to local governments.

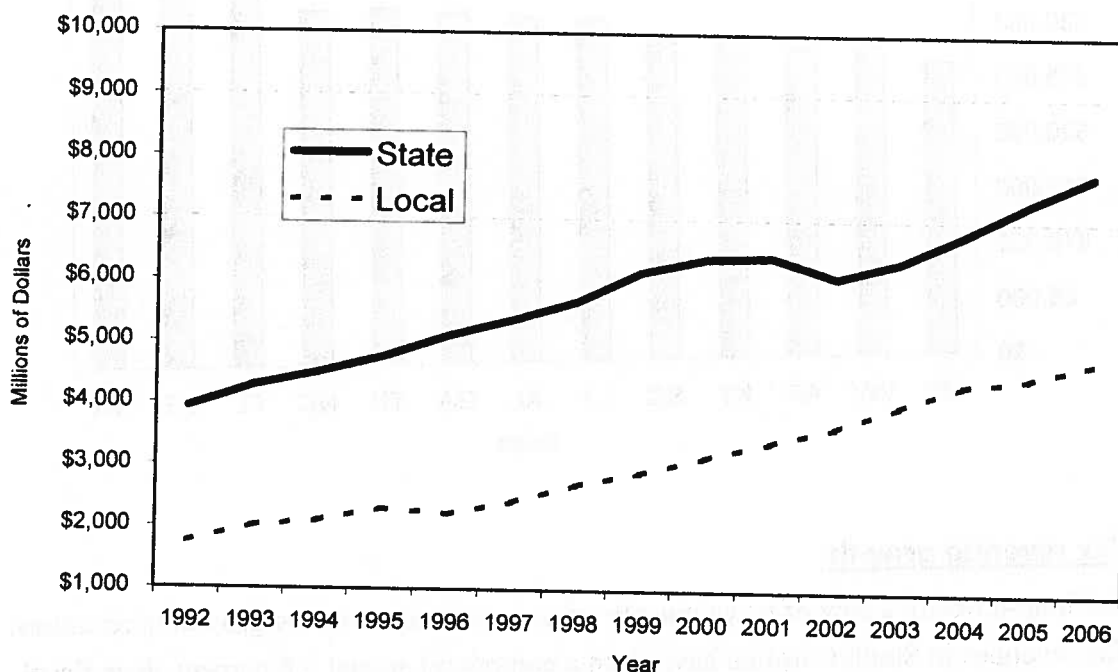
The issue remains whether the growth in revenues is appropriate. Normally, economists evaluate the appropriateness of a particular level of revenue growth using a concept called tax elasticity,⁵ which is calculated as tax revenue growth divided by personal income growth.⁶ Taxes are elastic if the calculation is greater than one, which simply

⁵ The term elasticity is normally applied if revenue growth is adjusted to exclude the effects of rate changes. The term buoyancy is normally used when no adjustment is made for rate changes. Nonetheless, we use the term elasticity despite making no adjustment for rate changes.

⁶ Personal income is a broad concept of income received by people including wages and salaries, self-employment earnings, transfer payments, and rents, interest, and dividends.

means that revenues grow faster than personal income. Taxes are said to be inelastic if the calculation is below one, which means that revenues grow more slowly than income.

FIGURE 5: South Carolina State and Local Tax Collections, 1992-2006



Many economists agree in concept that the revenue elasticity should be sufficient to finance the desired growth in state and local government expenditures, so that the capacity to finance services increases with the amount of services demanded. While this is a useful way to think about tax revenue growth, there is no agreement on how fast desired expenditures actually expand over time. A reasonable assumption is that desired expenditures rise at about the same rate as personal income. This is consistent with people wanting to spend a constant *share* of their income on such services as education, police and fire protection, and infrastructure.

South Carolina local government taxes were elastic and state government taxes were inelastic between 1992 and 2005 (see Table 1).⁷ Overall, taxes have been elastic, meaning revenues have grown faster than personal income. Local revenues have risen very rapidly as evidenced by all local taxes having high elasticities. Interestingly, among

⁷ Personal income grew a compound annual 5.31 percent annually from 1992 through 2005.

local taxes only the property tax had an elasticity below two (which means that the revenues from many taxes grew twice as fast as personal income), but the property tax dominates local taxes so the overall elasticity is about 1.4. The faster growth in taxes besides the property tax evidences that local governments have tended to diversify their revenue sources, with much greater use of the sales, selective sales and other taxes though the property tax continues to be the dominant local tax source. On the other hand, only the general sales tax had an elasticity above one among the state taxes. These results suggest that local government revenues have tended to grow faster than *desired* expenditures might be expected to rise and state government revenues have tended to grow a little more slowly than might be expected.

TABLE 1: South Carolina State and Local Elasticity Coefficients

Tax Category	State and Local	State	Local
Total Taxes	1.09	.92	1.42
Property	1.28	-.28	1.29
General sales	1.07	1.20	2.54
Selective sales	.94	.72	2.78
Individual income	.96	.96	--
Corporate income	.82	.82	--
Motor vehicle	1.00	.74	3.93
Other	1.16	.59	2.05
Source: Authors' calculations			

Bruce, Fox and Tuttle (2006) conclude that both the South Carolina state sales and income tax elasticities are a little lower than the national average, which is consistent with the conclusion in this report that state tax revenues have grown relatively slowly. Further, they find that South Carolina's sales tax revenues are very volatile across the business cycle, and particularly on the downside. That is, sales tax revenues perform very poorly when the economy is weak. On the other hand, the South Carolina income tax is less unstable than the national norm. Boyd (2007) examines the overall tax structure and finds important portfolio effects, which means the volatility of the tax system is lower than the volatility of the individual taxes. He concludes that the South Carolina tax system, though unstable, is less so than the median state. Nonetheless, the findings suggest the need for South Carolina to prepare for weak economic conditions by creating rainy day funds and other means to deal with unstable revenue growth.

The economic slowdown during 2000 and 2001 was mild when placed in the perspective of historical recessions, but state tax revenues were affected more than has been the usual pattern. An actual decline in tax revenues from one year to the next had not occurred in the modern history of aggregate state tax revenues, but the total of state tax revenues fell from fiscal year 2001 to fiscal year 2002. South Carolina's experience was similar to the average state and generally bears out the volatility of its revenue system. Indeed, South Carolina state tax revenues were lower in 2003 than in 2000.

Tax structure

South Carolina, as with all states, uses a range of revenue instruments to collect taxes, and the overall tax structure is similar to the U.S. average (see Figure 6). South Carolina governments rely slightly more on property, general sales, and individual income taxes than the national norm and slightly less on corporate income and selective sales taxes. South Carolina differs somewhat more from its neighbors, Georgia and North Carolina. Both states use the individual income tax more than South Carolina and the property tax less. Both states also use the corporate income tax somewhat more intensively than South Carolina. Georgia uses the general sales tax and North Carolina the selective sales taxes more than South Carolina. Motor fuels and miscellaneous selective sales taxes explain the greater concentration in selective taxes by North Carolina.

The differences between South Carolina and other *state* governments and between South Carolina *local* governments and other *local* governments are somewhat greater than for the aggregate. South Carolina state government relies more on both the general sales tax and the individual income tax than the average state and less on all of the other tax groups (see Figure 7). On the other hand, South Carolina uses the sales tax much more and the individual income tax much less than North Carolina and Georgia. South Carolina also uses the corporate income tax less than either state.

FIGURE 6: State and Local Government Tax Collections, 2005

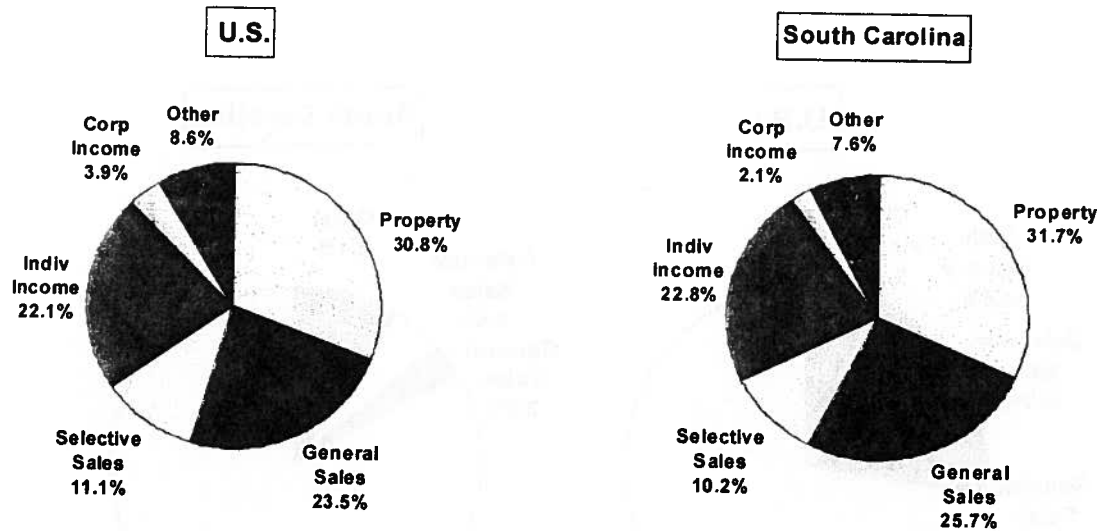
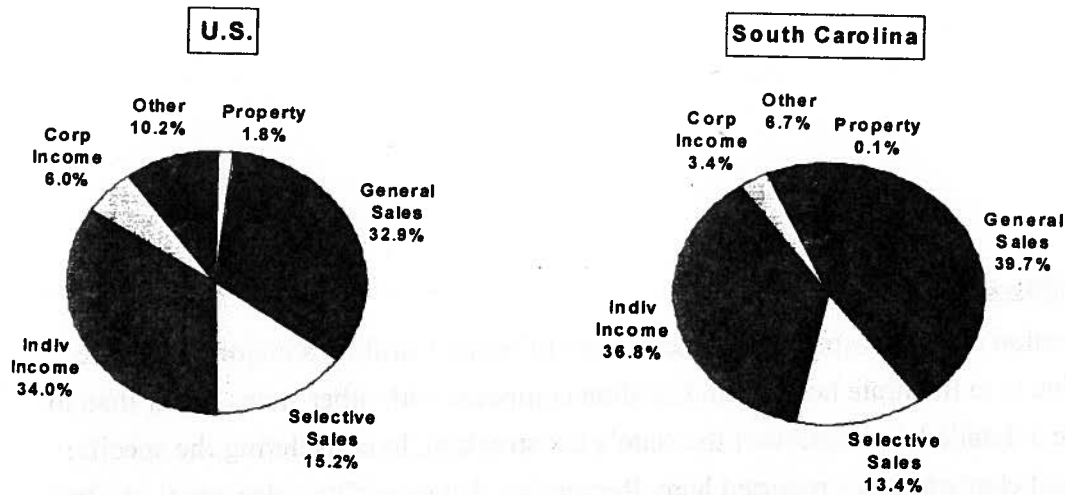
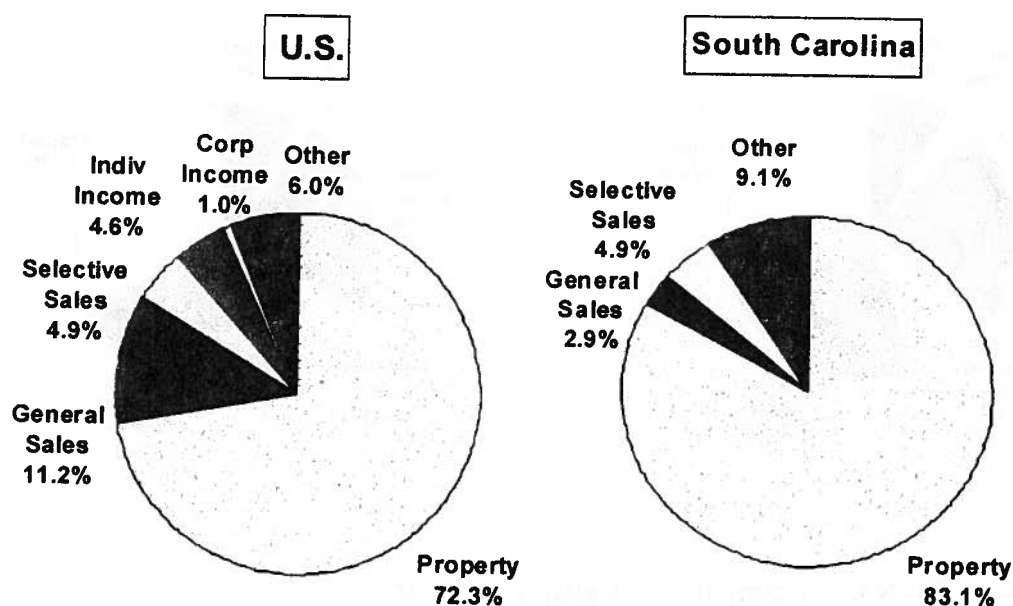


FIGURE 7: State Government Tax Collections, 2005



South Carolina local governments are concentrated much more in the property tax than the U.S. norm (see Figure 8). Local governments around the U.S. are given greater access to individual income and local sales taxes than are South Carolina local governments. Both North Carolina and Georgia allow their local governments greater access to local sales taxes, and this lessens the local government share of revenues coming from the property tax.

FIGURE 8: Local Government Tax Collections, 2005



Tax rates and bases

This section describes specific characteristics of South Carolina's major taxes. The objective is to illustrate how South Carolina compares with other states rather than to provide a detailed description of the state's tax structure. In considering the specific structural characteristics reported here. Remember that everything else equal, the best policy advice calls for low tax rates with broad bases. However, this does not mean the base should be expanded without careful consideration of the consequences of taxing each type of activity. High rates are reason for concern because the perverse effects of taxes on behavior rise with the rates.⁸

⁸ Indeed, the perverse effects of taxation increase with the square of the tax rate, meaning the effects rise very rapidly.

South Carolina's maximum individual income tax rate of 7.0 percent is tenth highest among U.S. states (see Table 2).⁹ The rate schedule is steeply progressive, starting with a 2.5 percent rate that is imposed on incomes below \$2,570. Rates of 3, 4, 5, and 6 percent are also applied to various income levels. As with most states, South Carolina's maximum rate is reached at a relatively low level of taxable income, \$12,850, meaning the tax structure is effectively proportional for many people in middle and upper income brackets. South Carolina's income tax rate structure has stayed essentially the same since 1992, except that the income brackets to which lower rates are applied have been widened. South Carolina's maximum rate lies between North Carolina's 7.75 percent and Georgia's 6.0 percent.¹⁰ North Carolina has a higher maximum rate, but it is only reached at \$200,000 of taxable income for a joint return. The allowance of deductions differs between South Carolina, Georgia and North Carolina, but not radically (see Table 2). All three also allow some pension income to be excluded in calculation of tax liabilities, with South Carolina lying between the other states.

South Carolina, as with most states, levies a flat rate on corporate income. Among states with a corporate income tax, only Colorado and Kansas impose rates lower than the 5.0 percent used by South Carolina and the median state imposes a 7.0 percent rate.¹¹ North Carolina has a 6.9 percent tax rate and Georgia has a 6.0 percent rate. South Carolina also levies a corporate franchise tax at \$1 per \$1000 of capital stock and surplus.

South Carolina imposes a 6.0 percent state sales tax rate and an average state and local rate of 6.9 percent. South Carolina's state and local rate is 18th highest in the U.S. and is very similar to the rates imposed by the average state and local government in Georgia (6.95 percent) and North Carolina (6.8 percent).¹² The state sales tax rate in both Georgia and North Carolina is lower than South Carolina's 6.0 percent. The state sales tax rate in South Carolina has been increased from 4 percent to 6 percent during the past 15 years. This follows a national upward trend in state sales tax rates, with the median state rate having been 3.25 percent in 1970 and almost half of the states having rates of at least 6.0 percent today.

⁹ Rhode Island imposes a rate equal to 25 percent of the federal rate, which may also exceed South Carolina's 7.0 percent for many people.

¹⁰ See http://www.taxadmin.org/fta/rate/ind_inc.html

¹¹ See http://www.taxadmin.org/fta/rate/corp_inc.html

¹² See <http://www.taxch.com/STRates.stm>

TABLE 2: Tax Structure Characteristics

Tax Characteristic	South Carolina	Georgia	North Carolina
<i>Tax Rates</i>			
Top income tax rate	7	6	7.75
Maximum income tax bracket	\$12,850	\$10,000	\$200,000
Sales tax rate	6.9	6.95	6.8
Corporate income tax rate	5	6	6.9
Cigarette tax rate per pack	\$0.07	\$0.37	\$0.35
Beer tax rate per gallon	\$0.77	\$0.48	\$0.53
<i>Structural Elements</i>			
Sales Tax on Food	3	Local rate	Local rate
Prescription Drugs	Exempt	Exempt	Exempt
Sales Tax Holiday	Yes	Yes	Yes
Private Pension Income Exemption	\$10,000	\$15,000	\$2,000
Standard Deduction	Federal	\$2,300	\$3,000
Exemption, Single	Federal	\$2,700	\$2,500
Sources: Individual Income Tax Provisions in the States, Wisconsin Legislative Fiscal Bureau, Jan. 2007; State Tax Clearinghouse; Federation of Tax Administrators.			

Both North Carolina and Georgia exempt food from the state sales tax and both impose the local sales tax on food. South Carolina has eliminated its 3.0 percent tax on unprepared food effective November 11, 2007. Thus, North Carolina and Georgia tax food at a somewhat higher rate because of the local tax. All three states are among the 15 states granting sales tax holidays. All three provide an August sales tax holiday and Georgia allows another holiday in October.¹³

South Carolina levies the lowest cigarette tax in the U.S., at \$0.07 per pack. This is well under the state median of \$0.95 per pack and the taxes imposed by Georgia (\$0.37) and North Carolina (\$0.35). On the other hand, South Carolina imposes the third highest tax on beer, at \$0.77 per gallon, which is much higher than the U.S. state median rate of \$0.188 per gallon.¹⁴ Georgia (\$0.48) and North Carolina (\$0.53) also levy lower rates than South Carolina.

¹³ See http://www.taxadmin.org/fta/rate/sales_holiday.html

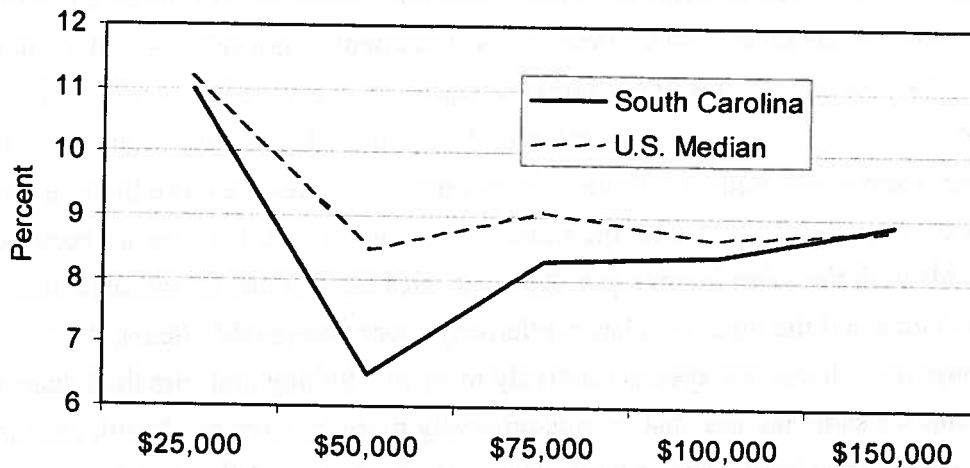
¹⁴ See <http://www.taxadmin.org/fta/rate/beer.pdf>

Tax Equity

Tax equity can be evaluated in terms of horizontal equity, treatment of households with the same capacity to pay taxes, and vertical equity, treatment of households with different capacities to pay taxes. Estimates of tax fairness require very detailed knowledge of who pays each of the various taxes, which goes beyond the scope of this study. Nonetheless, some general observations will be provided. Horizontal inequities are more likely to exist with narrow tax bases. Examples with the sales tax are easy to see. This occurs because two households with the same income pay different sales taxes if one purchases relatively more taxable items and the other purchases relatively more non-taxable items. A household pays more taxes if it spends relatively more on clothing and cars than does a household with the same income that spends relatively more on cosmetic health care and food for consumption at home. Broad tax bases are the best way to eliminate horizontal inequities.

Vertical equity can be measured by examining the tax burden for households with various incomes. The District of Columbia annually estimates tax burdens for households of three with incomes of \$25,000, \$50,000, \$75,000, \$100,000 and \$150,000 living in the largest city in each state. Columbia is used for South Carolina. The most recent report indicates that South Carolina's tax burden is regressive at the lowest income level, but proportional or slightly progressive at higher income levels. A regressive tax is indicated by a down sloping line and a progressive tax by an up sloping line in Figure 9. The equity implications for South Carolina's tax system are similar to the U.S. median state at the highest and lowest levels of income, but middle-income households have lower tax burdens in South Carolina.

FIGURE 9: Taxes as Percent of Income for 3-Person Households, 2005



Source: DC Chief Financial Officer.

Business Taxes

The extent of taxes imposed on business is a factor that should be considered in discerning the economic development effects of the tax system. As noted above, businesses should pay taxes according to the benefits received from public services, and taxes can be expected to have no implications for economic development to the extent they pay for these services. Unfortunately, no reliable estimates exist on the benefits that businesses receive from public services and so this report does not address the relationship of business tax payments to benefits received.

Businesses pay some form of almost every tax, and not just the taxes that are imposed only on business organizations. Corporations pay the corporate income tax, but are liable for many other types of taxes. For example, firms directly pay property taxes on their land and buildings and pay sales taxes on many purchases from other firms.¹⁵ Ring estimates that about 40 percent of the sales tax is collected on business input purchases.

A series of studies of total state and local business taxes¹⁶ has been conducted in recent years and indicates that South Carolina's share of taxes paid by business is qualitatively similar to the total tax burden.¹⁷ In 2005, businesses are estimated to have paid \$5.1

¹⁵ Business purchases are generally exempt from the sales tax if they are for resale or the products become component parts of manufactured goods, and for various other legislated purposes.

¹⁶ See Cline, Neubig and Phillips (2006).

¹⁷ The estimates are of initial incidence of taxes on business, and not final incidence. The taxes may be

billion in taxes in South Carolina, or about 41.5 percent of total state and local taxes. These taxes represented 4.4 percent of South Carolina Gross State Product.¹⁸ South Carolina taxes as a share of production are tied with two states for 33rd highest in the U.S., a little higher than the state's rank in total taxes. Of course, the recent sales tax increase is likely to raise the share of taxes paid by business.

The property tax accounts for 49.6 percent of South Carolina business taxes, and sales taxes on business input purchases for 19.5 percent. The combined property and sales tax share is similar to the national average, though South Carolina raises relatively more from the property tax and less from the sales tax. The corporate income tax accounts for only 4.8 percent of South Carolina business taxes. Thus, policy changes that affect the corporate income tax are of less importance for the business tax burden than are decisions on other general taxes such as the property and sales taxes.

Recent policy changes suggest a pattern of shifting the tax structure towards business. The property tax reductions have generally been targeted at lower taxes on owner occupied housing (see above), as have sales tax changes such as exempting food for consumption at home. Similarly, higher sales tax rates increase the tax on business input purchases. The business tax studies suggest that South Carolina business taxes and other taxes are growing at about the same rates. This may be because of rapid increases in residential property values along the coast that have tended to keep the residential share of property taxes higher. In the longer term, business tax burdens will remain lower than the national average, but businesses are likely to bear an increasing share of taxes if policy decisions continue as in the past. The general direction of these tax changes runs counter to the Palmetto Institute goal of designing a tax system for a more competitive South Carolina economy.

Other Studies of South Carolina's Tax Structure

The Palmetto Institute sponsored analysis of the South Carolina tax system during 2005 and 2006 that resulted in a series of working papers including those by Porca, Saltzman and Ulbrich (2005), Saltzman, and Ulbrich (2006), Schunk (2005), Steirer and Hite (2005), and Ulbrich (2005a, 2005b and 2005c). The research spanned such issues as the

shifted forward to consumers in higher prices, shifted backwards to labor (or other factors of production) through lower wages, or borne by business owners in lower profits.

¹⁸ Gross State Product is a broad measure of production in South Carolina.

South Carolina economy and tax structures, the historical development of the tax system, South Carolina budget processes, local government tax revenue, and a comparison of South Carolina with other southeastern states. The research is comprehensive and generally well done. The research is summarized and synthesized in Ulbrich (2005a).

Some of the major conclusions of the working papers are:

- Tax policy choices should be made based on consideration of the state and local system as an integrated structure. **Comment.** This is a point that we emphasized above as well, and is consistent with the pattern of tax changes in South Carolina over recent years where state tax revenues have replaced local revenues.
- Adequacy, equity and efficiency are the most important criteria for a good tax system. **Comment.** Focusing on these three issues means less attention to compliance cost concerns and political acceptability than we think is appropriate. Further, a focus on equity may be of less importance when the highly mobile economy indicates that competitiveness must be the driving issue for growing South Carolina's economy. Tax equity is a more important concern for national taxes.
- South Carolina needs both an adequate revenue system and sound budgetary practices. Off-budget funds, financing with nonrecurring revenues and earmarking are some approaches that create instability and inflexibility in the budget system. **Comment.** We certainly agree that South Carolina needs to establish and maintain an overall fiscal system that is sustainable and sound and that does not require frequent changes. This means that state and local government cannot be financed with a series of gimmicks, inflexible practices, and nonrecurring revenues.
- Most major South Carolina tax reforms have been based on independent, research-based analysis performed by outside agencies appointed by the General Assembly. Other major interest groups were generally involved in the analysis and discussions. **Comment.** The selling of a new plan will be the Palmetto Institute's biggest challenge. The Palmetto Institute will need an effective mechanism for involving other interest groups in designing and selling a plan that is intended to create a competitive fiscal structure for the future. Then, a means must be found to get buy-in from the General Assembly.
- Expected economic trends and demographic patterns will slow South Carolina's revenue growth. **Comment.** This is a very long-term issue and a difficult one on which to forecast. Certainly, a case can easily be made that growth will slow as the population ages and the U.S. becomes less competitive. But, the outcome depends heavily on the growth in labor productivity, labor migration within the

U.S., and many other factors that could enhance or retard South Carolina's relative growth. Regardless, South Carolina should structure its policies to maximize its competitiveness within the U.S.

- The burden of South Carolina's tax structure is low relative to other states. **Comment.** As was demonstrated above, while South Carolina does not have the lowest tax structure, the tax burdens placed on the state's residents are low compared with national norms, even when non-tax revenues are included in the calculations.
- South Carolina's revenue structure is similar to that used by most states, though some specific differences exist. Options exist for raising revenues without raising tax rates. **Comment.** The tax structure is similar to that used by the average state. Additional revenues could be generated through various base broadening measures, but the key issue is what are the best ways to design a competitive tax structure.
- Considerable pressure exists to reform the property tax system. The burdens are not high on average, but distribution of the burden has shifted both because of policy choices and relative growth rates of property values. **Comment.** As discussed above, some changes in the property tax have already taken place since the research was conducted.

Overall, the papers represent good quality work and are sound summaries of the South Carolina fiscal structure. Conclusions reached in the earlier papers are generally consistent with those found in this report and provide a basis for designing appropriate reforms in the structure.

Next Steps

Development of a tax reform plan that undergirds the South Carolina economy and serves as the basis for enhancing the new economy is the missing link of previous work. The papers only summarize and do not provide the path forward. The series of studies is informative and can be used in the educational and marketing of a plan, but the work stopped short of developing a specific tax reform strategy. The Palmetto Institute has identified competitiveness as the key factor that should drive any reform. The next step must be development of a detailed reform agenda that will result in a more competitive tax system for South Carolina. The plan must provide the necessary funding so that South Carolina can deliver essential education and infrastructure services while not harming the potential for business to start, expand and prosper in the state.

The following guidelines provide an initial framework for a competitive tax system. First, the structure must generate adequate revenues, both now and going forward, to allow South Carolina to invest in itself. The state must invest in its labor force through quality lifetime learning, K-12 education and higher education to compete with the rest of the world. Without these investments, the state's per-capita income and other measures of a competitive economy are likely to slowly decline relative to the U.S. South Carolina also must have the resources to invest in appropriate state of the art infrastructure to compete in the global environment. This guideline means that South Carolina should not see a "discount" tax structure and economy as its goal, but instead should ensure that appropriate revenues are generated for these essential investments. But it also means that taxes cannot and should not be too high.

Second, the state should seek broad tax bases and low rates. This does not imply that taxes should be imposed without careful thought about what belongs in the base. It means that tax concessions and other base erosion granted to reap short-term political gains must be kept to a minimum to allow the necessary revenues to be generated with low rates. Narrow bases are likely to lead to excessively high tax rates. Restrictions, such as Act 388, make it difficult to achieve the first two general guidelines.

Third, the tax system should be used sparingly to engineer the economy. Taxes on "social bads," such as alcohol and cigarettes, have an appropriate place in government finance. But tax concessions more generally are unlikely to enhance South Carolina's economy and are more likely to erode the tax base and result in higher marginal tax rates. Targeted tax concessions may be necessary in some cases, but should be the exception since South Carolina governments will not be as good at picking which firms and industries are likely to succeed as is the private economy. Similarly, significant efforts to alter the redistribution of income are generally inconsistent with broad tax bases and low tax rates. The national tax structure and targeted expenditures are better tools for achieving desired income redistributions.

Fourth, businesses should pay taxes because they benefit from public services. Increased business tax burdens should not be seen as a way to lessen the burden on individuals to achieve short-term political gains. Raising business taxes increases operating costs in South Carolina and makes the state a less attractive place to start, expand and locate economic activity. Growing economic mobility makes tax differentials increasingly

important to such business production decisions. Similar arguments hold with respect to tourism and related activity. Tourists should pay for the services they receive, but should not be seen as a means to extract significant payments to subsidize services for residents.

Finally, South Carolina should change the tax system infrequently. Any appropriate reforms should be identified and implemented and then the tax structure should be left alone while the state focuses on running good government and investing in itself. The business community prefers certainty about tax liabilities, which is inconsistent with frequent policy changes. Further, it is politically difficult to make changes in the tax system unless they erode the tax base.

Before adopting any significant changes in the state and local tax system, South Carolina should ensure that the proposed changes are studied carefully and objectively so that their potential impacts on taxpayers and the state's economy are well understood. Many of the consequences of Act 388 discussed in this report could have been identified in advance and made part of the public discussion, quite possibly leading to more-informed public decision-making. One way to accomplish this is to establish a permanent tax-study commission with responsibilities to conduct a periodic comprehensive study of the tax system and to analyze and report on significant proposed changes in the tax system.

Act 388 and Other Policy Changes

Over the last two decades the property tax burden in South Carolina was shifted to homeowners, while other forms of property were explicitly or implicitly granted tax relief: Inventories were exempted from the property tax; the property tax on cars was lowered, assessments on agricultural property were based on use value, and manufacturers were allowed to enter into “in-lieu” agreements that granted lower assessment ratios. The impact of these changes was blunted slightly by an exemption given to homeowners, but that was only partially funded. The net impact of these changes plus the operation of real estate markets was that between 1984 and 2004 assessed values for homeowners grew by an average of 7.7 percent per year while assessments for other classes of property grew by much less. (Gillespie, 2006)

In response to this rising property tax burden on homeowners, in 2006 South Carolina restructured its property and sales taxes through legislation and a constitutional amendment that slashed homeowner school property taxes, limited growth in property tax millage rates, capped property tax assessment growth, raised the sales tax, and shifted a greater share of school funding to the state. The main elements of this legislation were to:

- Eliminate the property tax on owner-occupied housing for school expenses other than general obligation debt service, beginning in 2007-08;
- Increase the state sales tax rate from 5 percent to 6 percent (effective June 1, 2007), other than for: unprepared food eligible to be purchased with Food Stamps, accommodations subject to tax at 7 percent, and items that were subject to a sales tax cap such as motor vehicles. (Note that food actually purchased with Food Stamps already was exempt from sales tax.) The revenue increase will be deposited in a Homestead Exemption Fund, along with funds used to finance existing homeowner property tax relief;
- Initially lower the sales tax rate on unprepared food from 5 percent to 3 percent (effective October 1, 2006), and in subsequent legislation eliminate the tax (effective November 1, 2007);
- Require the state government to reimburse school districts in the first year (2007-08) for lost revenue from property tax on owner-occupied housing on a dollar-for-dollar basis;
- Require state payments to school districts in future years (still called reimbursements) that, in aggregate, grow at the rate of inflation (Consumer Price Index) plus population growth. Individual school districts will receive an allocated

share of the total statewide increment based on their weighted student enrollment counts, with enrollment counts adjusted to give an additional weight of 0.2 for students in poverty, defined as those who qualify for Medicaid or free or reduced price lunch;

- Provide that the state will finance these reimbursements from the increase in its sales tax, or from the general fund if the sales tax is not sufficient;¹⁹
- Establish a cap on property tax millage increases for operating purposes for each individual local government (school districts and other governments) equal to the percentage increase in the CPI plus the percentage increase in population for the jurisdiction; and
- Impose a 15 percent cap on increases in individual property tax assessments over 5-year periods (adjusted for improvements), except when property is transferred. The 15 percent cap is constitutional, and the other changes are statutory.

We refer to these changes collectively by the name of the primary implementing legislation, Act 388, although some changes occurred after the initial enactment. We refer to the elimination of homeowner property taxes, the reimbursement from the state, and the caps on property tax millage rates as the property tax swap.

Act 388 will affect the amount of revenue that can be raised by local governments, alter economic incentives, alter the distribution of tax burden, and potentially affect the volatility of state and local tax revenue. These effects are discussed below. We briefly review Act 388 in the context of education finance, then examine the property tax swap and the assessment cap separately, and finally examine interactions between these two elements.

Act 388 and education finance

Act 388 is inextricably related to education funding in South Carolina.

The Education Finance Act of 1977 created the main system of state government funding for education, a foundation formula designed to fund “basic student cost” through local taxes and state aid. The EFA distributes aid to local school districts, taking into account revenue capacity through an Index of Taxpaying Ability based on local property wealth

¹⁹ In this analysis we focus primarily on longer-term impacts. However, the legislation also included provisions that affected short-term revenue flows, including provisions whereby the state holds local government harmless for the initial sales tax reduction on food.

(as defined by assessed value), and taking into account need through pupil weights that vary by grade level, learning disability, and other factors.

The Education Improvement Act of 1984 provided state funds for several different programs, including programs intended to raise student performance, emphasize basic skills, and evaluate teaching. The EIA increased the state sales tax rate by one percentage point, from four percent to five percent, to finance these programs. If state sales tax revenue falls short of the amount appropriated for education aid, the state has the authority to reduce EIA appropriations to maintain a balanced budget.

The state also finances a portion of prior state-mandated relief that was implemented through homestead exemptions, and provides several other forms of aid.

In 2005-06 school districts received approximately \$3.4 billion in revenue from the state, with Education Finance Act formula aid accounting for \$1.4 billion, Education Improvement Act programs accounting for \$530 million, and partial reimbursements for state-mandated local tax relief accounting for \$330 million. In 2007-08, state reimbursements for homeowner property tax relief under Act 388 are expected to be somewhat more than \$500 million.

Finally, even before Act 388 many school districts had restrictions on their legal abilities to raise revenue for education, and these restrictions varied widely. Of the state's 85 school districts, 23 had complete fiscal independence in that they had the ability to set millage rates and approve their own budgets, 36 had partial autonomy in that they could set millage rates within certain guidelines set by external bodies (such as the legislature, or a county council), and 26 have had no autonomy in that millage rates must be approved or set by an external body such as the legislative delegation or county council. (See Information Paper 2006; also Ulbrich and Steirer) It is not yet clear whether the millage limitations in Act 388 supersede these other restrictions on local autonomy, or whether the different sets of restrictions must be made to work in concert.

In many ways, Act 388 continues the trend of prior enactments, and is a move toward greater state funding of education and greater state control over the ability of local governments to finance education.

Property Tax Swap

Adequacy

State government.

Act 388 provides that the state will reimburse school districts from the Homestead Exemption Fund for lost property taxes on owner-occupied residences. In 2007-08 the reimbursement is dollar for dollar -- it will equal the amount that school districts would have raised for school operating purposes on owner-occupied residences. The total size of the fund will grow each year by the rate of inflation as measured by the Southeastern regional Consumer Price Index plus the growth in population for the state as a whole.²⁰ The fund will be financed by the sales tax increase, and if that is not sufficient, then the state will make up the difference from the general fund. If on the other hand, sales tax revenue exceeds required reimbursements, the remainder will be used to finance additional property tax relief. The requirement that the general fund make up any sales tax shortfalls is different from the pre-existing one percent sales tax dedicated to education under the Education Improvement Act of 1984, where the state may reduce appropriations to keep spending in line with revenue.

Will the sales tax be sufficient to finance reimbursements to local school districts?

We need to begin by looking at Act 388 from the perspective of state government as a whole, without regard to individual state funds. From this vantage point Act 388 as initially adopted amounted to a small revenue reduction for the state government on a full-annual basis. The one percentage point sales tax increase on items other than unprepared food and accommodations was expected to raise about \$582 million, and reimbursements to school districts plus related state funded property tax reductions were expected to cost about \$582 million. Reducing the sales tax rate on unprepared food from 5 percent to 3 percent was expected to cost about \$135 million, for a net revenue loss to the state of approximately \$135 million. However, the subsequent elimination of the sales tax on unprepared foods will cost an additional \$200+ million on a full-year basis, so that the full-annual net revenue loss to the state of the revised Act will be more than \$335 million, and will grow over time.

²⁰ The legislation refers to the Southeastern Consumer Price Index, but the relevant index from the US Bureau of Labor Statistics appears to be a Consumer Price Index for the entire South.

Next, we need to look at individual funds of the state, because this influences how the state will respond to the revenue loss, and which parties will be affected. The Homestead Exemption Fund will receive the full one percentage point sales tax increase on items other than unprepared food and accommodations, or \$582 million in 2007-08. It will make reimbursements to school districts for lost homeowner property taxes, plus other payments that in total will amount to approximately \$527 million (plus an additional \$55 million of property tax relief). Thus in its first full year the Homestead Exemption Fund will have more than enough revenue to finance its payments, and the remainder by law must be used for additional property tax relief, bringing the fund balance to zero.

The Education Improvement Act fund, which receives one percentage point of the sales tax and finances the special programs described above, will suffer a loss in revenue due to the new exemption for unprepared food. This amounts to roughly a \$67 million annual loss for the one percentage point of sales tax deposited to this fund. The legislation required the general fund to hold this fund harmless in the first year for its sales tax loss, but does not hold it harmless in later years. Since the general fund is not required to make up any shortfalls between revenue and appropriations, it is quite possible that EIA spending will be curtailed in the future.

Finally, the general fund will lose revenue for the remainder of the sales tax exemption for unprepared food, which will amount to a full-year loss of nearly \$270 million. Table 3 summarizes these impacts. The table shows that on a first full-year basis, the sales tax increase on items other than unprepared food, deposited in the Homestead Exemption Fund, will be sufficient to finance reimbursements to school districts plus additional tax relief. As the table shows, it is the General Fund and the Education Improvement Act Fund, not the Homestead Exemption Fund, that bear the cost of exempting unprepared food from the pre-existing 5 percent sales tax.

Will this also be true over the longer-term? The short answer is yes, on average. Revenue to the fund will grow at whatever rate the sales tax grows, while disbursements will grow at the rate of population plus the CPI. An analysis of South Carolina sales tax collections over the past 20 years shows that the sales tax has grown more rapidly than population plus the CPI, except in years associated with recessions, as Figure 10 shows.²¹ (The two

²¹ Source: U.S. Bureau of the Census, U.S. Bureau of Labor Statistics. Sales tax has not been adjusted for legislative changes, but there were not significant changes in the years in question.

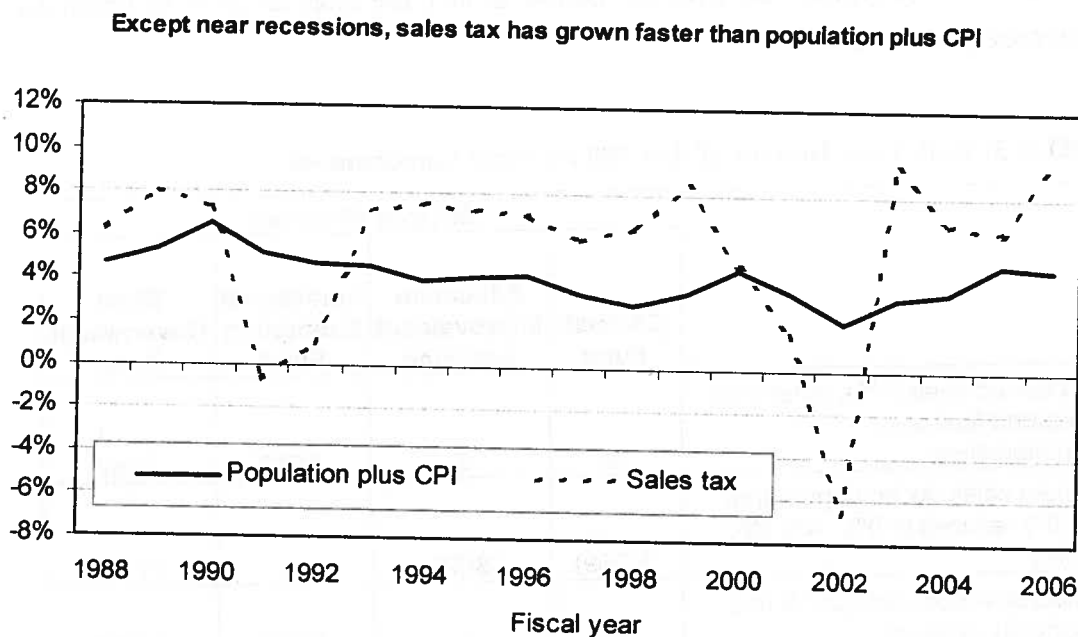
dips in the sales tax graph are associated with the 1990-91 and 2001 recessions, respectively.) In a typical year over this period, in fact, the sales tax grew by about 2.6 percentage points more.

TABLE 3: Full-Year Impact of Act 388 on State Government

	Millions of dollars			
	General Fund	Education Improvement Act Fund	Homestead Exemption Fund	State Government Total
Sales tax increase (1%), other than unprepared food and accommodations	\$-	\$-	\$582	\$582
Eliminate sales tax on unprepared food (5% reduced to 0% - 4% GF, 1% EIA)	\$(269)	\$(67)	\$ -	\$ (336)
Reimburse school districts for lost property tax revenue	\$ -	\$ -	\$(527)	\$(527)
Additional reimbursements for tax relief, to exhaust HEF funds	\$ -	\$ -	\$ (55)	\$(55)
Total	\$(269)	\$(67)	\$ -	\$(336)

Sources: Gillespie, Statement of Estimated State and Local Revenue Impact; and State Budget and Control Board, Three-Year General Fund Financial Outlook, December 2006.

FIGURE 10: Historical Growth in Sales Tax and Population Plus CPI



The main reason for this is that over time, real incomes tend to rise, reflecting productivity gains, so that the overall economy grows more quickly than does population plus inflation. Consumption purchases and sales tax revenues are tied closely to real incomes. Although the sales tax has not quite kept up with growth in the overall economy, it still has grown faster than population plus inflation, and in the typical year it is likely to continue to do so, meaning the Homestead Exemption Fund should usually have more than enough revenue to finance its disbursements.

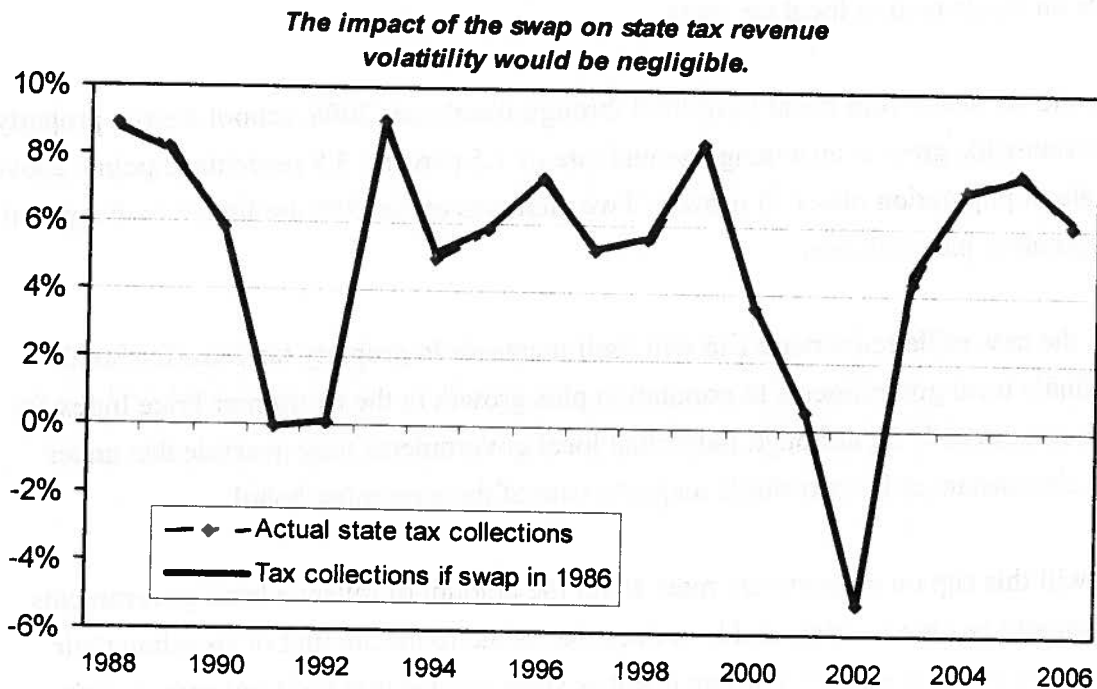
But what about those atypical years? In 1991 and again in 2002 sales tax growth fell far short of what would have been required to fund reimbursements. In 2002 sales-tax growth was more than 8 percent shy of what was needed – if that happened in the future, it would be large enough to generate a shortfall in the Homestead Exemption Fund of as much as \$50 million. Because the general fund is required to make up any shortfalls in the Homestead Exemption Fund this raises the question of how the sales tax increase affects the overall volatility of revenue used for other state purposes.

One way to gain insight into this question is to ask what would have happened if the swap had been enacted 20 years ago. We simulated the amount of revenue that South Carolina's state government tax structure would have raised if the swap had been adopted

in 1986 by adding a comparable amount to state sales tax revenue in that year, calculating total tax revenue in each future year using actual growth rates for the different tax sources, and calculating simulated total tax revenue and the growth in that revenue.

Figure 11 below shows growth rates for actual state government tax revenue and simulated state tax revenue (assuming a 1986 swap) over this time period. As is apparent, it is almost impossible to discern any difference in growth rates. Put differently, the swap would have had virtually no impact on the volatility of the overall state government tax revenue system. There are three reasons for this. First and by far most important, the sales tax increase, while considerable from a budgetary perspective, is still less than one 20th of the overall revenue system. Second, sales tax growth was fairly highly correlated (0.69) with growth in all other taxes. Third, while the sales tax can be volatile, over this time period it was not more volatile than other taxes.

FIGURE 11: Growth in State Tax Collections With and Without Swap



So the sales tax increase probably does not add much to the overall volatility of the state tax system. But that does not mean that school districts can safely count on reimbursements from the Homestead Exemption Fund. The more important point from

the local perspective is whether their new revenue source -- reimbursements -- is more reliable than their old revenue source, property taxes. And the answer there is a decided no. If the state suffers a significant shortfall in sales tax revenue, there is a good likelihood that other revenue sources -- particularly the income tax -- will suffer as well, and South Carolina will face difficult budget decisions. Under those circumstances it would not be surprising for the state government to scrutinize reimbursements and consider cutting them by passing legislation reducing transfers to school districts. By contrast, when the revenue source was property taxes on homeowners, school districts had much greater control - with properties being reassessed once every five years and with tax rates being set by government, property tax revenue need not respond quickly or sharply to an economic downturn.

Local governments.

The swap replaces a local revenue source that was controlled locally, albeit with limits on autonomy, with a state revenue source that will grow at the rate of population plus the CPI for the state as a whole but that will grow at different rates from district to district depending upon growth in the number of weighted pupils. In addition, the swap places limits on the growth in local tax rates.

Over the six years from fiscal year 2000 through fiscal year 2006, school district property taxes statewide grew at an average annual rate of 7.5 percent, 3.8 percentage points above the rate of population plus CPI growth. Two elements of Act 388 are linked to the growth in population plus inflation.

First, the new millage-increase cap will limit increases in property tax rates for South Carolina's local governments to population plus growth in the Consumer Price Index for the Southeastern U.S., although individual local governments may override this under some circumstances by two-thirds majority vote of the governing board.

How will this cap on property tax rates affect the amount of revenue local governments will actually be able to raise, and how does that relate to the amount of spending their citizens are likely to desire? The cap is not as strict as caps that limit revenue growth to population plus the CPI. Because it applies to millages, it allows local governments to tax normal growth in the assessed value base. If the property base is increased in a jurisdiction due to economic growth -- new construction and property improvements -- the government will be allowed to tax the growth. Fast-growing areas will be able to increase

revenue as a result of growth in population and CPI (allowing higher millage) and growth in the tax base.

Second, in school districts, property tax revenue from owner-occupied residences will be eliminated, replaced with reimbursements from the state that will grow, on average, at the rate of population plus CPI growth (with differences in population growth across school districts).

Will the combination of the cap plus the swap constrain local governments in the way intended?

Historical increases in local government revenue and spending

When people's real incomes increase, they choose to increase spending on most goods and services, including those provided by government. Real per-capita incomes generally increase over time – in most years and most states – and governments very often increase real per-capita spending over time. That is, government spending usually increases by more than population plus CPI growth. This tendency is broad and persistent.

For example, local governments in most states have been increasing spending at far greater than population plus the CPI, for very long periods. Table 4 shows the extent to which locally financed local government spending exceeded population plus the CPI. Regardless of which period we choose, local governments in virtually all states increased spending at a rate faster than growth in population plus the CPI, and the difference was usually substantial. For example, in the 10-year period ending in 2005, local governments in the median state increased spending by 2.7 percentage points more than population plus CPI growth in the average year and even the state at the 25th percentile increased spending by nearly a percentage point faster than population plus CPI. South Carolina, which traditionally has had much lower per-capita spending than most other states, has been increasing spending at a faster rate than the typical state. This may help to explain the tax revolt in South Carolina and enactment of Act 388, but the breadth and persistence across the nation also suggests widespread support for spending growth faster than population plus CPI.

TABLE 4: Local Government Spending

<i>Local governments in most states have spent faster than population plus CPI growth, over long periods.</i>				
Ten-year period ending in:	Number of states in which local government spending growth exceeded population plus CPI growth	Percent by which local government spending growth exceeded population plus CPI growth—annual average		
		State at 25th percentile	Median state	South Carolina
1990	49	4.2	5.6	8.2
1995	46	2.5	4.2	8.4
2000	43	0.9	1.9	4.7
2005	45	1.6	2.7	4.6

Source: U.S. Bureau of the Census, Bureau of Labor Statistics.

Within South Carolina, individual local governments usually increase spending at a rate faster than population plus CPI growth: total local government property taxes grew by 46.5 percent over the 10 years ending in 2005, which was 22 percentage points greater than the growth in population plus CPI. Property taxes grew faster than this cap in all but four counties, and grew 19.2 percent faster in the typical county.²²

Throughout this time period real income increased considerably in South Carolina and in the nation, and in fact increased much more substantially in South Carolina - between 1980 and 2005 real per capita income in South Carolina increased by 86 percent, and real per-capita income for the U.S. as a whole increased by 73 percent. (More recently, South Carolina's growth premium has slowed.)

Implications of the swap for local government revenue adequacy

Clearly local governments in South Carolina and around the nation – and perhaps their voters and taxpayers – have evidenced a broad and persistent desire for spending and revenue growth that exceeds the rate of population plus the CPI. Of course, the millage cap will not limit growth to this rate – when the tax base grows through improvements and new property, local governments will be allowed to tax this. These effects will play

²² Source: 2006 Local Government Finance Report, South Carolina State Budget and Control Board, Office of Research and Statistics.

out differently across South Carolina.

We simulated the combined effect of the millage cap and the property tax swap for school districts statewide under different growth scenarios, under the simplifying assumption that district reimbursements grow at the rate of population plus the CPI (i.e., where weighted pupil counts grow at the same rate as population). Under a baseline scenario where real assessed values increased at the same rate as the overall economy and federal and state aid and other non-property tax revenue kept pace with inflation plus CPI growth, total school district revenue increased at an annual average rate that was 0.6 percentage points greater than population plus CPI growth (driven by economic growth in its impact on the assessed value base). If school districts statewide seek to increase spending at rates consistent with recent history, here assumed to be 1.3 percentage points annually above population plus CPI growth, then revenue growth would not be sufficient to fund desired spending – after 10 years revenue would fall short of desired spending growth by 6.5 percent.

These impacts would vary greatly around the state. A district with no net additions to its tax base will not be able to increase property taxes enough to fund spending growth beyond population plus inflation and will have to scale back spending relative to what it otherwise would have been. At the other extreme, districts with rapid economic growth would have faster growth in taxable assessed values due to improvements and new construction. A district where the tax base is increasing rapidly could find itself with headroom if its desired spending does not grow rapidly – for example, a district where the real property value base is growing by 4 percent annually and where desired spending is increasing just one percentage point beyond population growth plus inflation will be able to keep millage increases below the cap and still fund desired spending.

But rapid economic growth can be a dual-edged sword. In a recent article, Schunk (2007) analyzed the difference between growth in state reimbursements and previous growth in tax revenue from owner-occupied residences for schools in fast-growing Horry County, and concluded that by the end of five years, annual reimbursements could fall \$5 million short of the taxes that might have been raised. Rapidly growing areas that also had rapid growth in desired spending (and taxes on homeowners) will find themselves constrained by Act 388. Figure 12 shows population growth and “excess” revenue growth (beyond population plus CPI) by county, from 1999-00 to 2005-06. Horry County certainly had rapid growth in revenue above and beyond inflation and population growth, but several

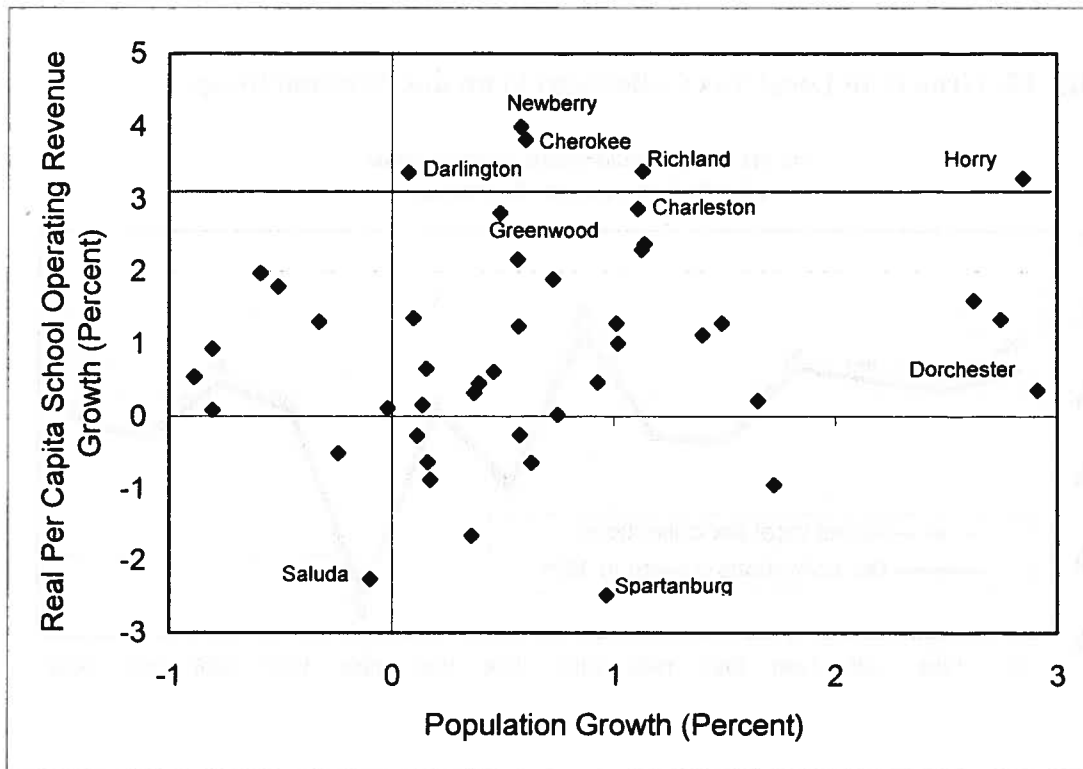
other counties had even more rapid revenue growth (above the horizontal line but with lower population growth than Horry) without the rapid growth in population that also drove Horry's tax base upward. These counties are likely to be even more constrained than Horry by the combination of the millage cap and the property tax swap.

In summary, schools in rapidly growing areas will have the greatest growth in their assessed value tax bases and their capacity to fund increases in spending beyond population growth plus the CPI. However, some of these counties – certainly Horry County – have also had rapid growth in desired spending, and will have to scale back spending growth to live within the millage cap.

This constraint may be precisely what South Carolina voters and legislators intended, but accomplishing it will require a sharp break from past revenue raising practices.

Furthermore, some desire for spending increases at the local level will be driven by state mandates. For example the South Carolina Association of School Administrators argues that state mandates to keep school district salaries competitive with those in other Southeastern states may require spending increases beyond what millage caps allow.

FIGURE 12: School District Population and Spending Growth by County, Average Annual Growth, 1999-00 to 2005-06

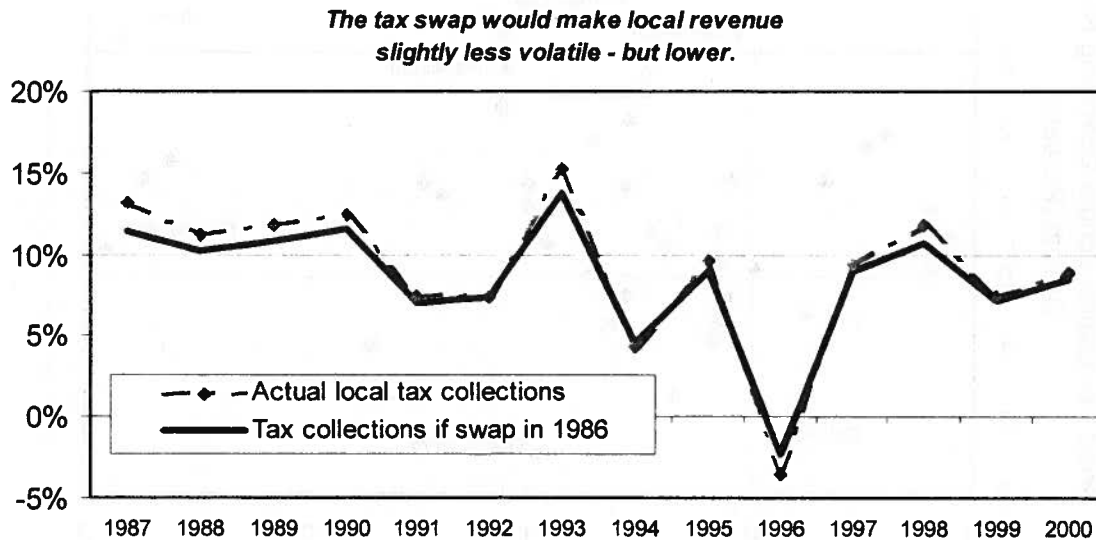


Another aspect of revenue adequacy is volatility. Viewed outside of the context of state politics and policy choices – that is, assuming the state fully funds property tax reimbursements with growth equal to population plus the CPI – the swap should make South Carolina's *local* government revenue system somewhat less volatile than before. Quite simply, the state government will provide the average school district a fixed amount of revenues in real per capita terms under the tax swap. While this holds on average, below we will show the reality is very different for individual school districts. Figure 13 shows the average impact of replacing the homeowner property tax for schools with a revenue source that grows at the rate of population plus the CPI.²³ Under the swap, the standard deviation of annual growth rates (a common measure of volatility) would have fallen from 4.4 percentage points to 3.7 percentage points, suggesting slightly lower

²³ Note: this simulation does not reflect the additional constraints on local revenue growth that would result from the millage cap. That would be likely to reduce revenue growth further, and to reduce volatility as well. Note further that this simulation ends in 2000 because it is based on data from the U.S. Bureau of the Census, which has gaps for several years after 2000.

volatility. But, the swap revenues are too small of a share of total local revenues to dramatically alter overall volatility.

FIGURE 13: Growth in Local Tax Collections With and Without Swap



But as discussed earlier, viewing volatility outside the context of state policy choices is probably not accurate or wise. Local school districts are now reliant on a revenue source that *could* grow in a stable manner *if* the state government does not change it. But the state tax system is far more susceptible to volatility over the business cycle than the local tax system, and if state revenue falls it would not be surprising if the state considers cuts in reimbursements. So potential volatility for local school districts has probably increased. Recent events in South Carolina have hammered the importance of revenue volatility home to school districts – a shortfall of \$30 million in the state’s Education Improvement Act funding for local school districts (funding that existed prior to Act 388) is leading many districts to consider cuts in spending for this year or next.²⁴

Equity

Impact on homeowners

Homeowners will always receive a property tax reduction under the swap. Whether they will face a sales tax increase or reduction depends upon how much they spend on

²⁴ Associated Press, April 9, 2008.

unprepared food versus other goods and services. The swap's initial formulation, with a three percent tax rate on unprepared food, would have led to a net sales tax increase on most families. However, with full elimination of the sales tax on unprepared food some families will actually have a reduction in sales tax despite the increase in tax rate.

According to the U.S. Bureau of Labor Statistics' Consumer Expenditure Survey, for households in the South with income below \$10,000 (about 10 percent of households), food purchases for consumption at home accounted for about 11 percent of total expenditures in 2005 and 2006 combined.²⁵ Because many expenditures are not subject to sales tax (such as for housing, health care, and insurance), food at home will be a much larger percentage of taxable purchases than it is of total expenditures. Food at home could amount to as much as 20 to 30 percent of taxable purchases for low-income families. For households with incomes of \$50,000 or more (about 40 percent of households), expenditures on food at home average about 5 to 7 percent of expenditures (declining as income rises), and probably average less than 15 percent of expenditures currently subject to sales tax.

For families currently paying sales tax on food purchases, if food at home constitutes about 17 percent or more of total taxable purchases, then they will receive a net tax reduction when considering the combined effect of the rate increase and the unprepared food exemption.²⁶ The bottom quintile of families by income is likely to spend this much on unprepared food. However many families with such low incomes are also likely to qualify for food stamps. Because purchases with food stamps are not subject to sales tax these families will not benefit from the exemption for unprepared food to the extent purchased with food stamps. Thus, families in poverty will pay the sales tax increase and obtain little or no benefit from the food exemption. In addition, many of these families are likely to be renters and will not benefit from the homeowner property tax reduction; in fact, they may end up paying higher rents to the extent property taxes are shifted to other properties and passed through to tenants.

Although the exemption for purchases of unprepared food will more than offset the sales tax rate increase for some families, the overall sales tax package will still raise more than

²⁵ BLS combines two years to compensate for small sample sizes.

²⁶ A family that had \$10,000 of pre-Act 388 taxable purchases would have paid \$500 of tax at a 5% rate. If one sixth of those purchases (16.67%) were for taxable unprepared food, then exempting those purchases and taxing the remaining \$8,333 of purchases at a 6% rate would also raise \$500.

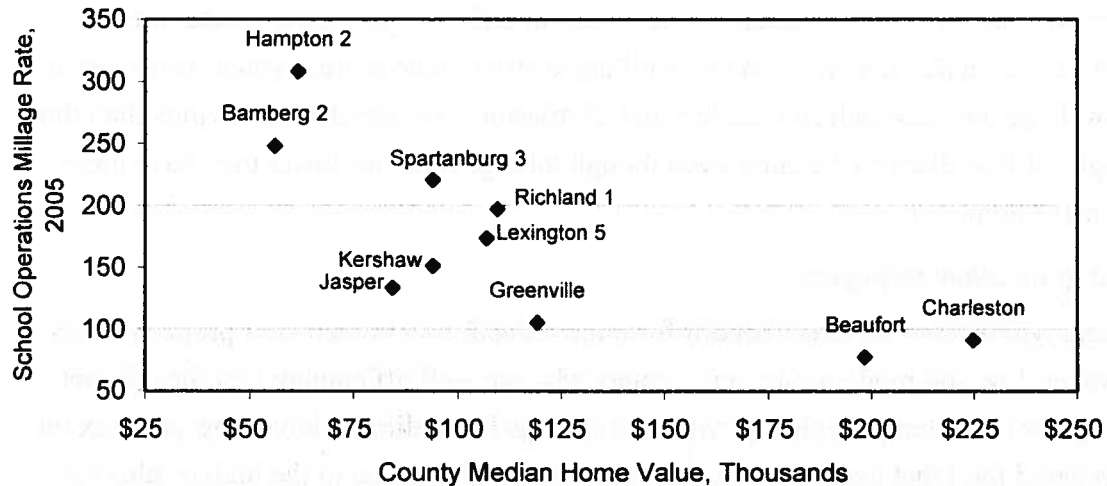
\$300 million annually, because families other than those with low incomes will pay more, tourists will generally pay the higher rate but will rarely benefit from the reduction for unprepared foods, and businesses will also face a tax increase. In fact, as noted elsewhere in this report, sales tax on business inputs is estimated to average around 40 percent of sales tax revenue (Ring, 1999).

Saltzman (2006) estimated the net impact of the property and sales tax changes for typical homeowners in different school districts at different income levels, under the original law (i.e., with the sales tax on unprepared food lowered to 3 percent). Her analysis generally suggested that within any given school district families with the highest incomes would benefit most largely because they own more expensive homes and will obtain the greatest property tax savings. We adjusted her numbers to take account of the elimination of the sales tax on unprepared food, and the same general conclusion still holds, although the benefits are slightly less skewed to those with highest incomes.

Saltzman also examined impacts across school districts, and noted that for a home of a given value, property tax reductions are greatest in the districts with the highest millage rates, which also tend to be the poorer districts. However, lower-income districts tend to have higher tax rates precisely because they don't have many high-income families with high-valued homes. Figure 14 shows the school millage rates in the selected districts included in the Saltzman analysis and the median home values for their respective counties. Median home values in Beaufort and Charleston counties are about three to four times those in Bamberg and Hampton. It is clear that districts with low home values, such as Bamberg 2 and Hampton 2, are unlikely to have many taxpayers with extremely high-valued homes, and so very few taxpayers will have huge tax reductions.

FIGURE 14: School Millage Rates and Median Home Values, Selected Districts

Districts with low home values tend to have higher millage rates.



Because of this it is useful to examine property tax savings for families with median home values in individual districts (with home values assumed to vary across districts). This takes into account the fact that the typical homeowner in Bamberg or Hampton is likely to have a much lower home value than the typical homeowner in Beaufort or Charleston. Table 5 below shows the results of these calculations.

TABLE 5: Estimated Property Tax Savings for Families With County Median Home Value, Selected Districts

<i>Typical families in high- and low-tax districts would have net tax reductions.</i>		
District	Millage Rate, 2005	Property Tax Savings
Beaufort	77.5	460
Charleston	91.1	637
Greenville	105.4	292
Jasper	133.5	225
Kershaw	151.2	284
Lexington 5	173.6	395
Richland 1	197.0	469
Spartanburg 3	220.6	414

Bamberg 2	248.0	278
Hampton 2	308.0	380

When we take into account actual home values in different parts of the state, it is not always the case that taxpayers in high-millage districts save more: typical taxpayers in low-millage districts such as Beaufort and Charleston have greater tax savings than those in high-millage districts, because even though millage rates are lower they have more expensive homes.

Impacts on other taxpayers

Renters will receive no direct benefit from the reduction in homeowner property taxes. However, low and moderate-income renters who are well off enough that they do not qualify for food stamps typically will have savings from elimination of the sales tax on unprepared food that exceed the higher taxes they will pay due to the higher sales tax rate. Middle and upper income renters generally will pay more sales tax than before due to their relatively greater expenditures on goods and services subject to the new higher rate.

As noted earlier, perhaps the taxpayers most affected by the swap are poor families who rent. As renters they will not benefit from the property tax reduction. If they qualify for food stamps they will not benefit from the new exemption for unprepared food, since food purchased with food stamps is already exempt. And they will pay a one percentage point sales tax increase on all their taxable purchases. Furthermore, to the extent that property taxes on businesses, including landlords, are raised and are passed through to renters, they will end up paying higher rents.

As noted above, businesses will not benefit from the reduction in property taxes, and are unlikely to obtain much benefit from the exemption for unprepared food, but they will pay the increase in the sales tax. In aggregate this increase is likely to be about \$250 million per year based on the finding in Cline, Neubig and Phillips (2006) that suggests that businesses pay more than 50 percent of South Carolina's sales tax through taxes on business input purchases.²⁷ Thus, the business share of local school costs has gone up by at least 4 percent. Over time business will see its share rise as it pays the school property tax at higher rates plus the growing sales tax.

²⁷ Estimates in Ring (1999) indicate that the business share of the sales tax is approximately 40 percent.

Impacts across the state

Act 388 and the distribution of reimbursements for property taxes

As observed earlier, school districts will receive dollar for dollar reimbursements for lost property taxes in 2007-08. In later years the total pot will grow at the rate of population plus the consumer price index, and each district will share in growth based on its share of total weighted pupils. This will tend to disadvantage fast growing districts. A fast-growing district is likely to have been able to increase its property taxes on homeowners at a rapid rate - if the number of pupils was rising because of new housing developments, the district would have been able to capture that growth in its tax base. However, the replacement formula does not increase payments to fast growing jurisdictions as rapidly.

Table 6 below illustrates this issue. Two districts, Slow-growing District A and Fast-growing District B start out with the same reimbursement and numbers of weighted pupils in year 1. Each receives \$10 million of reimbursements in year 1, out of total reimbursements of \$850 million (this is a few years in the future). Each receives an average of \$1,000 per pupil. The total reimbursement pot is assumed to grow at 4 percent based on the rate of population growth plus the CPI, yielding an additional \$34 million to be distributed in year 2. District A has weighted pupil growth of 1 percent (100 additional pupils) and District B has weighted pupil growth of 10 percent (1,000 additional pupils).

Each district receives a share of the incremental total reimbursements (the \$34 million) based on its share of total weighted pupils (not total *new* pupils). Because the shares change very slowly each gets almost the same incremental revenue despite the fact that District B had 10 times as many additional pupils as District A. As a result, in year two District B now receives only \$948 per total weighted pupil while District A receives \$1,029 per total weighted pupil. And District A received \$3,961 of incremental reimbursement per incremental pupil while District B received only \$431 of incremental reimbursement per incremental pupil. Fast-growing districts are unlikely to receive increases in reimbursements that keep up with either pupil growth or the growth in tax revenue they might otherwise have received.

Act 388 and the Index of Taxpaying Ability

Act 388 is intricately related to the funding of education in South Carolina. Under the Education Finance Act, the state determines a defined minimum program and calculates a

total state cost for this program (cost per student times a weighted pupil count). The state government funds 70 percent of this total statewide amount by making aid payments to school districts; local school districts are assumed to fund the other 30 percent. The amount each individual district receives is determined by (1) calculating the cost of the minimum program in that district (statewide cost per student times the district's weighted pupil count), (2) and calculating the district's assumed local share, which is based upon a measure of its relative wealth called the Index of Taxpaying Ability times the statewide local share.

The Index of Taxpaying Ability for any given school district is essentially the district's assessed value as a percentage of the statewide assessed value total. Under Act 388, even though owner occupied residences are removed from the school district tax base for operating purposes, the assessed values of these properties continue to be included in the Index of Taxpaying Ability.

TABLE 6: Distribution of Act 388 Reimbursements

Illustration of how Act 388 reimbursements affect slow and fast-growing districts.

	Slow-growing District A	Fast-growing District B	Statewide
Reimbursement in year 1	\$10,000,000	\$10,000,000	\$850,000,000
Share of reimbursement, year 1	1.18%	1.18%	100.00%
Population plus CPI growth to year 2			4%
Increase in total reimbursements			\$34,000,000
Weighted pupils, year 1	10,000	10,000	850,000
Growth in weighted pupils to year 2	1%	10%	2%
Increase in number of weighted pupils	100	1,000	17,000
Weighted pupils in year 2	10,100	11,000	867,000
Share of weighted pupils, year 1	1.18%	1.18%	100.00%
Share of weighted pupils, year 2	1.16%	1.27%	100.00%

Incremental reimbursements (based on weighted pupils share, year 2)	\$396,078	\$431,373	\$34,000,000
Total reimbursement, year 1	\$10,396,078	\$10,431,373	\$884,000,000
Share of reimbursement, year 2	1.18%	1.18%	100.00%
Reimbursement per weighted pupil, year 1	\$1,000	\$1,000	\$1,000
Reimbursement per weighted pupil, year 2	\$1,029	\$948	\$1,020
Incremental reimbursement per increment pupil	\$3,961	\$431	\$2,000

Consider the school districts of Jasper and Lexington. Approximately 14 percent of Jasper's assessed value is for owner occupied residences, while 42 percent of Lexington assessed value is for residences. As the EFA funding amount rises over time, the assumed dollar cost of the local share will also rise. However, the local share increase will fall on a greatly narrowed base in Lexington because 42 percent of the assessed value will now be excluded from tax whereas in Jasper only 14 percent will be excluded. Because the Index of Taxpaying Ability does not exclude the assessed value of owner occupied residences, it implicitly presumes that school districts have the capacity to raise their local share from property that they are not allowed tax. This might not be a major issue if Act 388 reimbursements from the state to school districts matched the amounts that districts might otherwise raise locally, but for reasons discussed elsewhere, there is little reason to believe this will be the case. Table 7 ranks the counties by the owner-occupied share of assessed value in 2005, with those at the top being most likely to have difficulty financing the local share of revenue implicit in the Index of Taxpaying Ability.

TABLE 7: Percent Share of County Assessed Value, Owner-Occupied Residence

County	Owner-occupied residence % share of county assessed value, Tax year 2006	County	Owner-occupied residence % share of county assessed value, Tax year 2006	County	Owner-occupied residence % share of county assessed value, Tax year 2006
Lexington	42.01	York	30.78	Dillon	24.31
Pickens	39.11	Charleston	30.47	Chesterfield	24.11

Dorchester	38.85	Laurens	30.47	Darlington	23.59
Aiken	34.50	Saluda	30.27	Orangeburg	22.81
Greenville	34.29	Clarendon	29.93	Greenwood	22.43
Richland	34.21	Berkeley	29.79	Horry	20.83
Edgefield	33.33	Sumter	29.68	Oconee	20.25
Marion	33.24	Bamberg	29.58	Colleton	19.92
Kershaw	33.20	Beaufort	28.50	McCormick	19.38
Anderson	32.71	Florence	27.62	Calhoun	19.30
Lancaster	32.66	Hampton	27.33	Williamsburg	18.38
Abbeville	32.47	Newberry	26.26	Fairfield	16.35
Marlboro	32.19	Georgetown	25.90	Allendale	14.89
Lee	31.86	Cherokee	25.69	Jasper	14.14
Union	31.23	Barnwell	24.99		
Spartanburg	31.04	Chester	24.98		

In other instances when the state reduced school districts' capacity to raise local revenue, it has also adjusted the Index of Taxpaying Ability to remove the value of property that school districts no longer could tax. This was true with fee-in-lieu arrangements with manufacturers, and with tax increment financing arrangements. (South Carolina Department of Revenue, 1999)

There are at least two possible ways of addressing this in Act 388. One would be to simply exclude owner-occupied residences from the assessed value calculations used in the Index of taxpaying ability. However this really is not correct, because it ignores the fact that school districts are receiving revenue from the state that at least up until 2007-08 was related to the value of owner-occupied residences - the reimbursements. An alternative approach that would take this into account would be to calculate the implicit assessed value equivalent of owner-occupied residences based on reimbursements actually received from the state. This is essentially what is done in the case of fee-in-lieu property.

Economic effects

The swap alters the relative prices of property and sales taxable transactions thereby potentially changing certain decisions. The swap will make business and rental properties

relatively more expensive than owner-occupied residential properties, making investments in these properties less attractive than before. Homeowning will become relatively more attractive, and renting will be relatively less attractive.

The higher sales tax rates will create disincentives to purchase in South Carolina vis-à-vis other states. Online purchases, in cases where no sales tax is collected, will become relatively cheaper (because the tax savings are greater). The elimination of unprepared food from the tax base will make purchases of exempt food relatively more attractive, for example, encouraging eating at home rather than in restaurants.

Assessment-increase cap

The assessment cap limits assessment increases to 15 percent over any 5-year period (Amendment 4, 2006 general election; Acts 12 and 57, 2007). Improvements would be assessed at market value, and properties will be reassessed to market value when sold (when an “assessable transfer of interest” occurs).

The cap is the successor to a previous cap that had been enacted in 2000. That cap was a local-option 15 percent limit that applied to homeowner assessments only and was implemented in Charleston but nowhere else. It was challenged in court and invalidated because it did not apply to all classes of real property and was not imposed uniformly statewide. (Gillespie, 2006) The new assessment-increase cap, enacted in 2006, applies to all classes of real property and is imposed statewide, so it corrects both of these infirmities although it may be challengeable on other grounds.

South Carolina is not the only state with an assessment-increase cap. California's Proposition 13 was among the first of these caps. Among other things it limits increases in assessments on individual properties to 2 percent a year until the property changes hands. Georgia has a county option assessment limit and has debated a constitutional limit that would restrict assessment increases to 3 percent a year. Florida's Save Our Homes cap imposes a limit of 3 percent or the rate of inflation, whichever is less. Illinois enacted a local-option law in 2003 that provides for a 7 percent limit, with certain maximum benefits, and Cook County adopted this law in 2004. In total 11 states impose assessment limits that are similar to South Carolina's in two key respects: they apply to individual properties rather than just to the aggregate value of property in an assessing district, and the cap does not apply when the property is transferred. About half of these

caps apply only to homeowner property.²⁸

Assessment-increase caps are one very dramatic way to respond to issues raised by rapidly rising property values and property taxes, but they are not the only way. Some states have adopted other approaches that are more targeted and that do not raise some of the issues these caps raise.

Adequacy

The assessment-increase cap should not affect revenue adequacy in any direct and significant sense, although there will be some small impacts. For example, the assessment cap will lower property values relative to market values in fast-growing districts where property owners hold onto properties for a long time. This could flow through to the Index of Taxpaying Ability, reducing the local contribution required by the EFA formula and actually increasing the receipt of state formula aid for education. In addition, the reduction in assessed values relative to market values could also lead to lower debt limits in some jurisdictions.

Equity

By design, assessment caps create horizontal inequities. Two properties of equal value in the same taxing jurisdiction can be subject to very different taxes based simply upon when they were purchased and their rates of appreciation over time. For example, suppose there are two houses next to each other on the same block. One house was purchased last year for \$100,000 and is assessed at that now. The other house was purchased 15 years ago for about \$31,500 and increased in value by 8 percent per year so that it is now worth \$100,000. As a result of the assessment cap its current assessment is limited to about \$47,900. If overall property taxes in the area amount to 2 percent of assessed value, the recently purchased house will be subject to \$2,000 in taxes while the long-held house will be subject to only about \$960 in taxes. The owners of the first house will pay more than \$1,000 in additional tax--more than double what the owners of the nearly identical house right next door pay.

Although this may seem to economists and many other observers like unequal treatment of equals, when a similar issue was litigated in California in relation to Proposition 13, it was found to be a legitimate distinction. It has been upheld in other states as well.

²⁸ See Sexton, Table 1; Bowman 2006; Dye, McMillen, and Merriman 2006a and 2006b; and Hawkins 2006.

The properties that benefit most from assessment caps tend to be those that are held for long periods of time, particularly in the areas that are appreciating rapidly. Past research has shown that elderly households and low income households tend to be less mobile than other households and tend to hold their properties for longer periods of time.

Table 8 shows the counties sorted by the percentage of households that had been in the same home for 20 years as of the 2000 Census. In general, many of the counties that have the longest periods of tenure have been in slower growing parts of the state and often have lower average incomes than those areas that have high tenure. That does not necessarily mean that households in counties such as Union and Fairfield will in fact benefit more from the assessment cap than households in rapidly growing areas such as Horry and Beaufort. The assessment will tend to shift property tax within counties so that Union will not benefit at the expense of Beaufort (except indirectly through mechanisms such as the EFA formula). Rather, larger numbers of households in Union may benefit but at the expense of other households in Union.

TABLE 8: Percent of Households in Same Home for 20 Years or More, By County

County	Percent	County	Percent
Union	59.7	Statewide avg	49.7
Fairfield	58.8	Spartanburg	49.4
Marlboro	58.8	Jasper	48.9
Williamsburg	58.3	Laurens	48.4
Saluda	57.7	Anderson	48.3
Hampton	57.1	Florence	48.1
Lancaster	55.8	Kershaw	47.8
Newberry	55.6	Aiken	47.4
Allendale	55.2	Sumter	46.9
Chester	54.6	McCormick	46.0
Lee	54.2	Colleton	45.9
Bamberg	54.0	Pickens	45.8
Abbeville	53.7	Richland	45.6
Calhoun	53.2	Charleston	45.0
Orangeburg	53.1	Greenville	44.6

Marion	53.0	Oconee	44.4
Dillon	52.7	Berkeley	42.9
Darlington	52.3	Georgetown	42.7
Chesterfield	52.0	York	42.2
Edgefield	51.8	Lexington	41.9
Clarendon	51.3	Dorchester	40.5
Cherokee	51.1	Horry	34.6
Barnwell	51.0	Beaufort	28.6
Greenwood	49.8		

Source: 2000 Census of Population

Assessment caps can actually create a “winners who lose” effect. An assessment-increase cap, by itself, will not lower property taxes. What it does is lower property taxes for some property owners at the expense of others. Furthermore, even some people who appear to benefit from an assessment cap actually will pay more. Suppose for example that all households in a given taxing jurisdiction had their property assessments capped. If the total tax levy stays the same then it will need to be reallocated among properties and that will occur in a fashion that gives the greatest tax reductions to the properties with the greatest limitations on their assessments, but that ends up increasing taxes on properties where the cap had only a small effect.

Dye, McMillan, and Merriman examined this effect for the 7 percent assessment cap in Cook County, Illinois using detailed assessment and property sale records, and concluded that while two thirds of parcels eligible for the assessment cap paid lower taxes, fully one third of parcels eligible for the assessment cap ended up paying higher property taxes due to the tax shift. (Dye, McMillen, and Merriman. 2006a.)

While we did not have detailed property-by-property assessment and sale records, we were able to construct a simulation model that analyzed key elements of the assessment-increase cap under different plausible sets of assumptions. We begin with a set of properties assumed to be assessed at full value initially. We make different assumptions about the average property value growth rate in the likelihood that a property will be sold in any given year. We also assume that not all properties increase at the average rate but rather that they are normally distributed about the average. These properties then increase or decrease in market value under different scenarios and are sold periodically.

Assessments are adjusted over time to reflect changes in market values, except that assessments cannot increase by more than 15 percent over any five-year period when the same owner holds property. When property changes hands assessments are revised to reflect current market values.

We then distribute property taxes across the properties based upon their assessed values and compare that to how property taxes would be distributed if based upon market values. Finally, we calculate the percentage of properties that pay more tax under the assessment-cap regime than they would in absence of the cap. As discussed above even some properties ostensibly benefiting from the assessment cap will pay more than they would in absence of the cap. Table 9 below shows the results of these simulations for the 15th year after the cap is in effect, under different sets of assumptions.

TABLE 9: Illustrative Simulation of Impact of Assessment Cap on Property Taxes, Fraction of Properties Paying at Least 10% More than the Average Effective Tax Rate After 15 Years

<i>Large numbers of taxpayers would be "losers" under the assessment-increase cap.</i>						
	2% probability of sale, on average, in any given year		5% probability of sale, on average, in any given year		10% probability of sale, on average, in any given year	
Average property value growth rate	<i>Capped "losers" as percent of properties with capped assessments</i>	<i>All "losers" as percent of all properties</i>	<i>Capped "losers" as percent of properties with capped assessments</i>	<i>All "losers" as percent of all properties</i>	<i>Capped "losers" as percent of properties with capped assessments</i>	<i>All "losers" as percent of all properties</i>
3%	-	-	-	-	-	-
5%	16.2	22.5	13.6	28.5	5.4	35.6
7%	17.3	21.7	22.9	32.7	19.3	39.0
9%	16.5	20.1	26.7	34.5	25.2	40.7

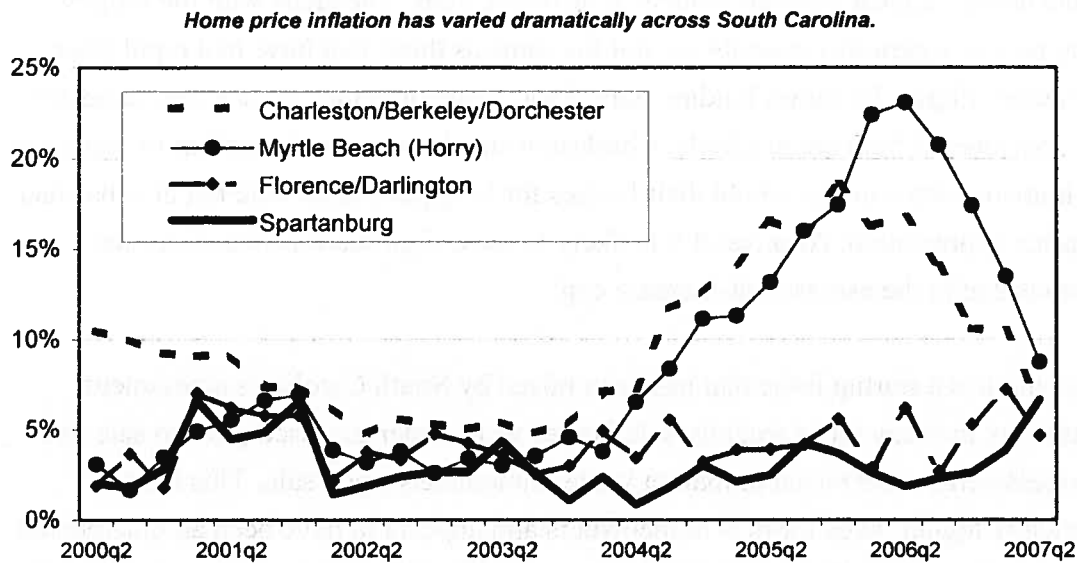
Additional assumptions:

- 68% of properties have market value growing within plus or minus 3% of average rate
- 95% of properties have market value growing within plus or minus 6% of average rate

As is clear from the table large numbers of properties will be losers under a wide range of assumptions. For example, in an area where property values grow by 5 percent per year on average and where only 2 percent of properties turn over per year (an average of once every 50 years), at the end of 15 years 22.5 percent of properties will pay at least 10 percent more tax than they would in the absence of a cap. And 16.2 percent of properties ostensibly benefiting from the cap would nonetheless pay at least 10 percent more in taxes. As the turnover rate of properties increases and as the average growth rate in property values increases, the numbers of properties that would pay more in tax under the assessment cap tends to grow. If properties increase on average at about 9 percent per year and if they tend to be sold on average about once every 10 years (a 10 percent probability of sale), then about 41 percent of all properties pay higher taxes with the cap than without and about 25 percent of capped properties pay higher taxes. Finally, not shown in the table, the longer the cap is in effect the larger these impacts.

Which areas of South Carolina are most likely to feel these effects? Until recently there have been huge disparities in the growth rates of property values. Figure 15 below shows the growth in home value prices from the Freddie Mac conventional mortgage home price index, for selected South Carolina MSAs. Prices were heated in the Myrtle Beach (Horry County) MSA, growing by more than 20 percent in the second quarter of 2006 and they were increasing almost as rapidly in the Charleston Berkeley Dorchester area, growing by nearly 20 percent at the end of 2005. By contrast prices were growing much more slowly in Florence and Darlington County, and in Spartanburg and several other areas of the state, growing by only about 5 percent or so. But as the graph shows, prices in the rapidly growing areas are now growing much more slowly although they were still above their prior-year levels through the second quarter of 2007.

FIGURE 15: Home Price Changes, Year Over Year



Source: Freddie Mac Conventional Mortgage Home Price Index: MSA Series, Q2 2007 Release

Table 10 below shows the percentage change in home prices between the first quarter of 2000 and the second quarter of 2007 for four major MSAs that include part of South Carolina.

TABLE 10: Percentage Change in Home Prices, by MSA, 2000Q1 through 2007Q2

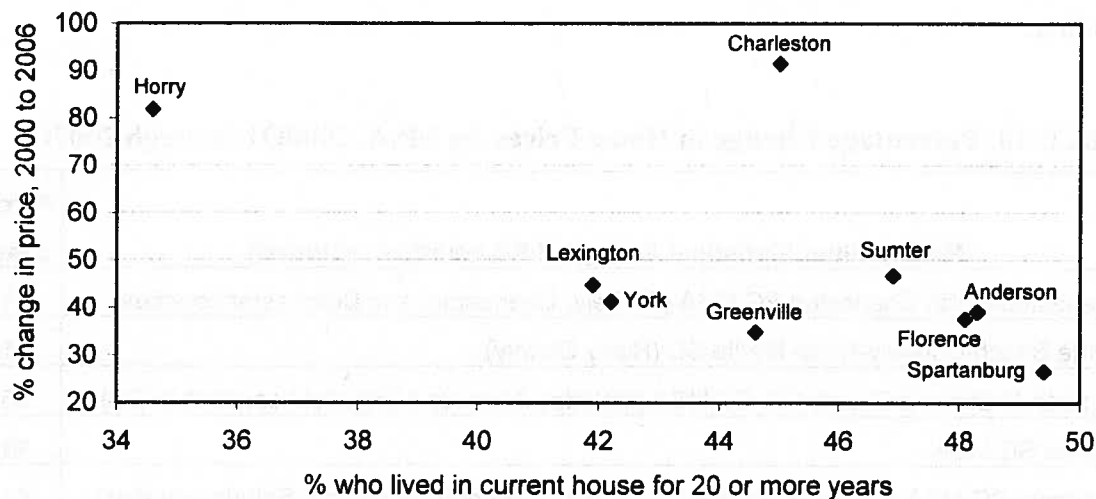
Metropolitan Statistical Area (and SC counties included)	Percent change
Charleston-North Charleston SC MSA (Berkely, Charleston, and Dorchester counties)	91.5
Myrtle Beach-Conway-North Myrtle SC (Horry County)	81.8
Augusta-Richmond County GA-SC MSA (includes Aiken and Edgefield counties in SC)	55.1
Sumter SC MSA	46.7
Columbia SC MSA (Calhoun, Fairfield, Kershaw, Lexington, Richland, Saluda counties)	44.7
Charlotte-Gastonia-Concord NC-SC (includes York County in SC)	41.2
Anderson SC MSA	39.1
Florence SC MSA (Darlington and Florence counties)	37.7
Greenville SC MSA (Greenville, Laurens, and Pickens counties)	34.8
Spartanburg SC MSA	26.5

Source: Freddie Mac Conventional Mortgage Home Price Index: MSA Series, Q2 2007 Release.

The data above suggest different effects in different areas. The areas with the longest holding property periods generally are not the same as those that have had rapid price appreciation. Figure 16 shows holding period and tenure together for selected areas for which measures of both are available. Charleston stands out as an exception in that it has many homeowners who have held their houses for long periods of time but also has had rapid price appreciation. As a result it is likely to have significant dislocations and distortions due to the assessment-increase cap.

Finally, there is a startup issue that has been raised by South Carolina's assessment-increase cap. In many areas recently sold homes were under-assessed prior to sale and their assessments were raised to market value immediately upon sale. This led to dramatically higher taxes for new homeowners and appears to have been an unexpected impact of the new law. This effect has been especially evident in coastal areas. (See for example, Beaufort Gazette September 10, 2007, Island Packet September 9, 2007, and Myrtle Beach Sun Times, September 5, 2007.)

FIGURE 16: Home Price Changes and Household Tenure, Selected Areas



Economic effects

Because the assessment-increase cap is lifted when property changes hands, there can be very dramatic increases in taxes upon the sale of property that has been held for a long time. For example, suppose that an elderly couple lived in a home they purchased 30 years ago for \$35,000 and that the property increased in value by about 6 percent per year

but their assessment was limited to an increase of 3 percent per year. At the end of 30 years their house would be worth about \$200,000 but would be assessed at \$85,000. If the total tax rate in the jurisdiction was 2 percent, they would be paying property taxes of about \$1,700 per year but a new owner would have to pay taxes of \$4,000 per year. This is a substantial disincentive to sell and discourages mobility, which makes the economy less efficient.

Several economists have studied this issue. O'Sullivan, Sexton, and Sheffrin (1995) simulated the optimum time people should hold their homes under annual reassessments and alternatively under a tax based on acquisition value, assuming that property appreciates at six percent annually and is taxed at a rate of three percent. They concluded that a tax based on acquisition value increases the time a typical owner would hold property by about 18 percent, and created an "excess burden" of 4.5 percent (excess burden is a measure of the loss to society due to the distortion of economic decision-making). Wasi and White (2005) examined the question empirically, and concluded that holding periods in California were about 6 percent longer than in Florida and Texas as a result of Proposition 13. They also concluded that the increase in holding periods was greatest where property values are highest or are increasing rapidly. Stohs, Childs, and Stevenson (2001) also examined the question empirically and concluded that as a result of Proposition 13, California's homeowners are significantly less mobile than their counterparts in Illinois and Massachusetts. Several other papers also have found that taxes based on acquisition value limit homeowner mobility and lengthen home holding periods. Finally, one paper, which examined an assessed value freeze in Muscogee County, Georgia found no significant impact on mobility (Sjoquist and Pandey, 2001).²⁹

Because South Carolina's assessment-increase cap applies to all properties, businesses will face the same kinds of incentives and their decision-making will be distorted similarly. So, for example, if a new business wants to come in and buy a manufacturing plant from an existing business that is no longer able to operate efficiently--a move that might be very good for society and for South Carolina's economy--the new business might have a disincentive to do so because it would pay far higher taxes than the existing business in the same location. And more generally, long-standing businesses would have a competitive advantage relative to potential newcomers when considering operating at the same kind of site. Businesses also will have incentives to arrange their affairs--the

²⁹ This review is based in part upon Sexton (2007).

structure of corporate ownership and the like--in a fashion that minimizes taxes even if there is not a good business purpose (other than tax savings) for such arrangements.

Modifications and alternatives to assessment caps

Assessment caps have many disadvantages. They create disincentives for mobility, to the detriment of both households and businesses, creating economic distortions that are bad for the overall economy. They create horizontal inequities. They shift taxes from some households and some taxpayers to others and often increase taxes on those who might otherwise appear to benefit. They are a sledgehammer approach to the problem of rapidly rising property taxes.

Governments that have adopted assessment-increase caps often have found themselves unhappy with their effects, and have modified them. There are many other options to reduce the burdens of rapidly growing property taxes that are more targeted than assessment caps. For example, circuit breakers that target tax reductions to low income or elderly families can achieve this effect, and methods of smoothing and delaying property tax increases that are less dramatic than assessment caps have been used in other states. (Bowman 2006)

Summing up the effects of Act 388

The overall thrust of Act 388 is to narrow the base of the sales tax and increase the rate and to narrow the base of the property tax, which will likely result in property tax rate increases.

It is likely to constrain the growth of revenue in many school districts relative to what they might otherwise have done, particularly in districts that have been raising revenue at rates above the growth of population and inflation and that have not seen significant growth in the assessed values due to improvements in new construction.

The property tax changes will shift the burden of new growth in property taxes disproportionately to businesses. In addition the assessment cap will provide benefits to long-term property holders at the expense of people and businesses holding properties for shorter periods of time, so that similarly situated properties will be subject to different tax burdens based upon holding periods and historical property value growth. In the case of homeowners, within a taxing jurisdiction beneficiaries are likely to be disproportionately

elderly and lower income. However, many property owners who appear to be benefiting from the cap will not benefit because taxes will be shifted to them as a result of the cap.

The sales tax changes will hurt families that are poor enough to purchase their food with food stamps, because they will not benefit from the exemption for unprepared food (their purchases are already exempt) but they will still pay a higher tax rate. Low-income families that are not poor enough to benefit from food stamps are likely to get a net benefit from the sales tax reduction. Middle-income and upper income families generally will receive a net tax reduction from a combination of the property tax swap and the sales tax increase. Households that rent are much more likely to pay additional taxes than are homeowners. Businesses are likely to experience tax increases, both from the property and sales tax changes.

The property tax changes, by narrowing the tax base, are likely to lead to higher rates. Within school districts the vast preponderance of these increases will have to come from properties other than owner-occupied residences. Thus, effective tax rates on businesses are likely to rise. This will create disincentives to locate businesses in South Carolina and to own nonresidential property in South Carolina.

In addition, the property tax changes will make property markets less flexible, imposing potentially large penalties on transactions involving properties held for long periods of time (i.e., taxable property values will rise dramatically at time of sale). New investments in South Carolina that rely on purchases of property will be disadvantaged relative to businesses already in place. There will be incentives to hold properties longer, to avoid transactions, and to structure business affairs in ways that minimize taxes even if they do not make the greatest economic sense. This makes the South Carolina economy less efficient. The sales tax changes also narrow the tax base and raise the rate and will provide a relative advantage to unprepared food, at the expense of other goods and services subject to sales tax.

South Carolina Revenues and Recession

In May and June of 2007 the South Carolina Board of Economic Advisers released an analysis stating that "...a contraction will come, most likely within a fairly short time horizon" and assessing how a recession beginning in the first quarter of 2008 might affect the state's finances. The BEA projected a revenue shortfall of \$1 billion by 2010, annual shortfalls of about \$1 billion in 2011 and 2012, and continuing shortfalls through 2015. At their greatest point, the projected shortfalls amount to 15 percent or more of the budget. BEA assumed in its analysis that the next recession will be very similar in its impact on state tax revenue to the 2001 recession. As discussed below, the 2001 recession had an extraordinarily severe impact on the tax receipts in South Carolina and in the nation as a whole due in part to special circumstances related to capital gains. We explore these issues below.

While this analysis is focused on a recession, it is important to remember that state tax revenue in South Carolina and elsewhere is very sensitive to economic conditions more generally. Even without a recession, a sharp slowdown in the economy could have very negative effects on revenue and finances. However, recessions are extreme events and typically hit state finances particularly hard.

Likelihood of a Recession

Recessions do not occur simply because the time has come. Often they are triggered by the undoing of imbalances or excesses in the economy, or the impact of exogenous shocks. However, the unwinding of the subprime mortgage lending excess is constraining credit, reducing asset values and the ability to spend, and shaking consumer and business confidence. Record high oil prices are constraining the ability of consumers to spend in other areas of the economy. All of these have increased the odds that we are in recession as of early 2008.

And in fact there are signs and predictions that the probability of a recession has been increasing:

- Economic forecasters such as Global Insight are now indicating that we are in recession.
- A November 2007 *Wall Street Journal* survey of approximately 55 economists indicated that about one third of these forecasters expect a recession sometime in the next six months, up from one quarter during the summer. A similar percentage

continues to say we are in recession according to CNN Money.

- Larry Summers, a former secretary of the U.S. Treasury, wrote in the *Financial Times* of London during the Fall of 2007 that “the odds now favour a U.S. recession that slows growth significantly on a global basis”. (Summers)
- A popular market for futures contracts on political and economic events suggests that market participants believed the probability of a recession in 2008 was approximately 47 percent at the end of November (www.intrade.com).

Total U.S. employment has declined three consecutive months through March 2008 according to the business survey, amounting to 232,000 jobs. The losses are all accounted for in the private economy, which has fallen four straight months. The job losses are essentially all in the goods producing side of the economy, including manufacturing and construction. As a result, the unemployment rate has risen from 4.4 percent in March of 2007 to 5.1 percent in March 2008.

We may not be in a recession right now, but the economy has certainly slowed down significantly. Tax collections do not have a linear relationship with economic performance and can decline especially sharply during a recession, as we will show.

“Great Moderation” – Recessions and Economic Volatility Have Been Moderating

While a recession is popularly thought of as two consecutive quarters of decline in real gross domestic product, the actual definition is more complex. The National Bureau of Economic Research, a widely recognized arbiter of recessions, defines a recession as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.” (Hall, et al., 2003)

The economy has become less volatile in recent decades, with the variability of growth in real output declining by half since the mid-1980s. Economists have analyzed this extensively and have dubbed it the “Great Moderation.” (Bernanke, 2004) This decline in volatility has occurred not just in the national economy but also in the economies of individual states. In fact, since about 1983, volatility in employment growth has declined in every state with a median decline of about 38 percent. South Carolina has participated in this trend, with a decline in employment variability of about 30 percent. (Carlino, 2007)

Economists have offered three potential explanations for this decline in volatility: structural change, improved monetary policy, and good luck. The structural change explanation suggests that improvements in technology, improvements in management of inventories, the increasing sophistication of financial markets, and changes in other structural aspects of the economy may have made it easier for the economy to absorb shocks. The policy explanation suggests that greater success in monetary policy at managing inflation has led to lower volatility in the real economy. The “luck” argument suggests that the economy has been subject to less-frequent and less-severe shocks in the last several decades. Obviously, which explanation is most important will determine whether the economy is likely to continue to be less volatile than it used to be or whether we have simply been lucky. Unfortunately, the jury is still out and economists continue to analyze these questions. Ben Bernanke, the current chairman of the Federal Reserve Board, has argued that improved monetary policy has made an important contribution to the decline in volatility. (Bernanke, 2004)

Recessions generally also have become shorter and less severe, and expansions have become longer, particularly in comparison to the pre-World War II era. Since then, recessions have been quite variable, with the 2001 recession being the mildest on record by some measures. In fact, using the recession-marking quarters designated by NBER, real GDP did not decrease during the recession, although there was a small decline by some measures.³⁰

Table 11 shows the depth and duration of postwar recessions, and the length of the expansion leading up to each recession. In contrast to the 2001 recession, the 1973-75 and 1981-82 recessions were relatively deep. The expansions preceding the two most recent recessions have been long by historical standards, with the pre-2001 expansion being the longest on record. The expansion since 2001 lasted at least 72 months if we are currently in a recession, and that would be the fourth longest since World War II.

³⁰ In some other respects the 2001 recession was deeper than it appears by the GDP summary measure. See Banerji, 2002.

TABLE 11: Post-War Recession Statistics

<i>Recessions vary enormously in depth and duration, and the most-recent one was mild.</i>			
Recession	Gross domestic product percent change	Duration of contraction (months)	Length of prior expansion
1948-49	-1.7%	11	37
1953-54	-2.7%	10	45
1957-58	-3.2%	8	39
1960-61	-1.6%	10	24
1969-70	-0.6%	11	106
1973-75	-3.1%	16	36
1980	-2.2%	6	58
1981-82	-2.6%	16	12
1990-91	-1.3%	8	92
2001	0.0%	8	120
Post-2001			72 (Nov 2007)

Sources: National Bureau of Economic Research for recession dates, and U.S. Bureau of Economic Analysis for GDP change.

Recessions Differ in Their Character

Recessions differ not only in their depth and duration but also in their character. Different kinds of recessions will have different impacts on the tax receipts of state governments. For example, a recession characterized by a steep drop in consumption might have especially severe impacts on a state that relies heavily on the sales tax, while a recession with steep declines in business investment might have its largest impacts on the economies and therefore taxes of states with heavily industrialized economies as was true in the 1980-82 recession period.

Each postwar recession has had a unique character, as shown in Table 12. The deep 1973-75 recession included a dramatic 26.8 percent drop in investment that was larger, in dollar terms, than the entire drop in gross domestic product. Consumption, by contrast, accounted for only a small portion of the drop in GDP. The 1980 and 1981-82 double dip recessions also were driven by investment declines, while consumption actually increased during the 1981-82 period. The 1990-91 recession was notable because consumption

played a much greater role, accounting for nearly two thirds of the decline in total GDP. Finally, the 2001 recession is notable because it was mild in many respects.

TABLE 12: Percent Change in GDP Components, Peak to Trough

<i>Recessions differ in their character.</i>				
	Gross domestic product	Consumption	Investment	Government
1973-75	-3.1%	-0.6%	-26.8%	4.6%
1980	-2.2%	-1.2%	-15.9%	-1.1%
1981-82	-2.6%	2.9%	-22.5%	3.9%
1990-91	-1.3%	-1.1%	-10.1%	1.4%
2001	0.0%	0.7%	-4.7%	1.5%

Sources: National Bureau of Economic Research for recession dates, and U.S. Bureau of Economic Analysis for GDP components

Recessions Vary Across States

The economic performance of individual states varies considerably during national recessions, reflecting the characteristics of a particular recession, the characteristics of state economies, and other factors. Table 13 below shows the composition of the South Carolina economy compared with the U.S. as a whole in 2005. The private sector is a smaller portion of the South Carolina economy than it is in the nation as a whole, and since government tends to be more stable during recessions, that fact in isolation would tend to make the South Carolina economy somewhat more stable.

Within the private sector South Carolina relies far more heavily on cyclical manufacturing than does the national economy as a whole and relies less on most services and especially financial services. Depending on the character of a particular recession, this might or might not add stability to South Carolina's economy. It suggests that a manufacturing-dominated recession, such as the 1980 recession, would be difficult for South Carolina, while a recession that hits the financial services industry harder as in 1990-91 and 2001 might be relatively better for South Carolina. Other factors come into play as well.

TABLE 13: Shares of Total Gross Domestic Product, 2005

<i>South Carolina Economy Compared With United States.</i>			
	United States	South Carolina	South Carolina minus United States
Gross domestic product	100.0%	100.0%	-
<i>Private industries</i>	88.0%	83.8%	-4.2%
Manufacturing	12.2%	18.0%	5.7%
Mining	1.9%	0.2%	-1.7%
Wholesale trade	6.0%	5.9%	-0.2%
Retail trade	6.7%	8.1%	1.5%
Information services	4.5%	2.7%	-1.8%
Finance, insurance, real estate, rentals	20.5%	15.6%	-4.9%
Professional and technical services	7.0%	4.4%	-2.6%
Health care and social assistance	6.9%	5.8%	-1.1%
All other private industries	22.3%	23.2%	-1.1%
<i>Government</i>	12.0%	16.2%	4.2%
State and local government	8.6%	11.7%	3.1%
Federal government	3.4%	4.5%	1.1%

Source: U.S. Bureau of Economic Analysis

Quarterly data on state gross domestic product by sector are not available, but we can analyze changes over the course of a recession using employment data. In the 2001 recession, employment in the United States as a whole declined by 1.5 percent from the start of the recession to the recession's trough, and ranged from a decline of 2.6 percent in Massachusetts to an increase in employment of 1.6 percent in Wyoming. South Carolina fared somewhat worse than average, with a decline of 1.9 percent.³¹

³¹ To analyze the employment data, we obtain monthly data from the U.S. Bureau of Labor Statistics, convert it to quarterly data, and then seasonally adjust using the Census X11 ARIMA methodology. We begin with unadjusted data because a far longer time series of these data is available from BLS than is true for seasonally adjusted data.

During the last three recessions South Carolina has performed worse than the nation for a substantial part of each recession. Each line in Figure 17 below represents the cumulative relative performance of employment in South Carolina since the start of a recession, compared with the U.S. When the line is above the bold horizontal axis it means that the cumulative impact on South Carolina was better than the national average and when the line is below the axis it was worse. The solid line shows the 1980 recession - the recent recession in which South Carolina performed worst relative to the nation. Ten quarters into that recession South Carolina's employment had declined by 1.6 percentage points more than U.S. employment had declined. (South Carolina's employment had declined by 3.5 percentage points, while U.S. employment had declined by 1.9 percentage points.) South Carolina also performed somewhat worse than the U.S. in the 1990 and 2001 recessions, in the sense that employment in South Carolina fell earlier than employment in the U.S. However, two years after the start, South Carolina's recovery was actually stronger than the U.S. recovery in each of those two recessions.

FIGURE 17: South Carolina vs. U.S., Recession Performance

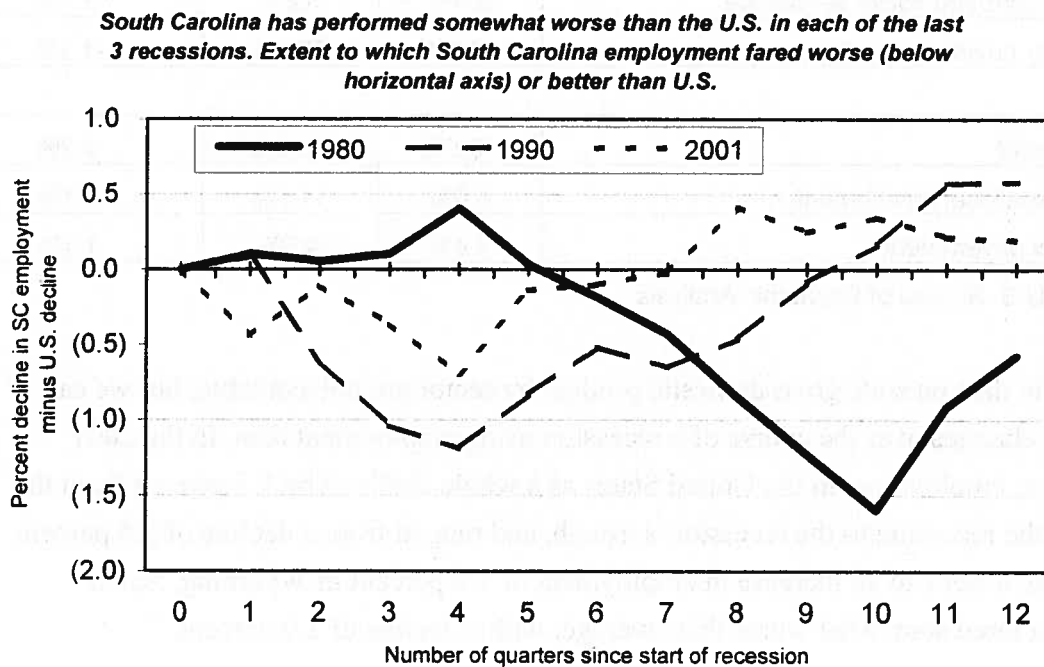
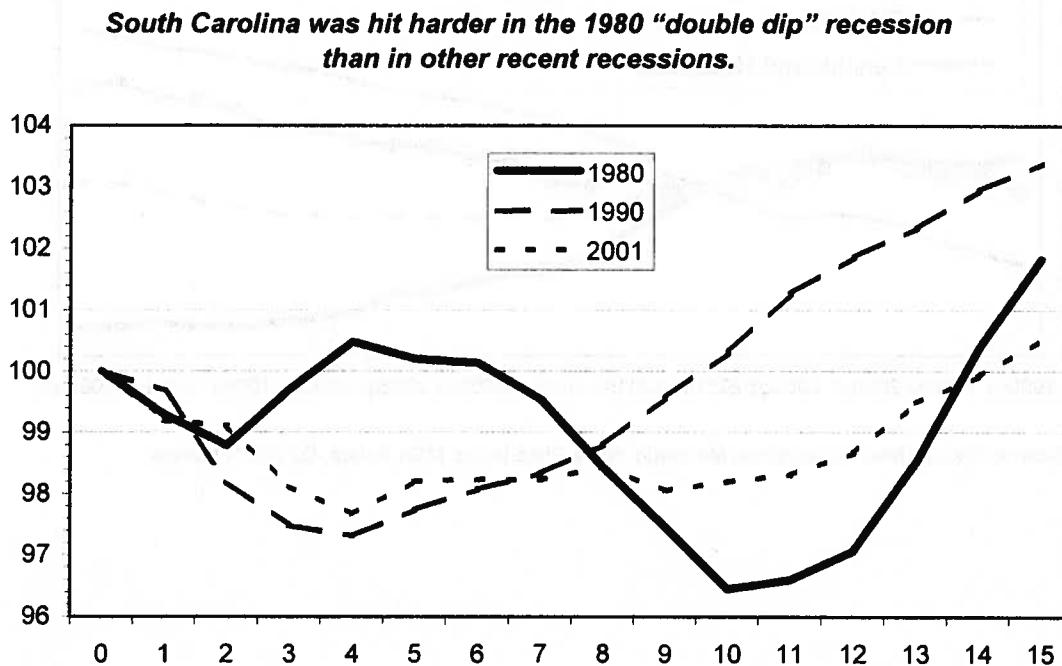


Figure 18 below shows employment in South Carolina indexed to the start of each recession. The 1980 recession was worse for South Carolina than either of the other two.

We also see that the 2001 recession was somewhat shallower than the 1990 recession, but the longest in duration of the three.

South Carolina has not been hit hard by the economic slowdown as yet, though some signs are pointing to weakness. South Carolina, as with the U.S. as a whole, has experienced recent employment declines, with a 15,900 reduction over the past two months. The job losses have been primarily in construction and manufacturing. Still, employment remains 9,000 above March 2007 and the 5.7 percent unemployment rate for March 2008 is the same as last March. The unemployment rate is lower than the 6.2 percent at the end of 2007.

FIGURE 18: South Carolina Employment Indexed to the Start of 3 Recessions



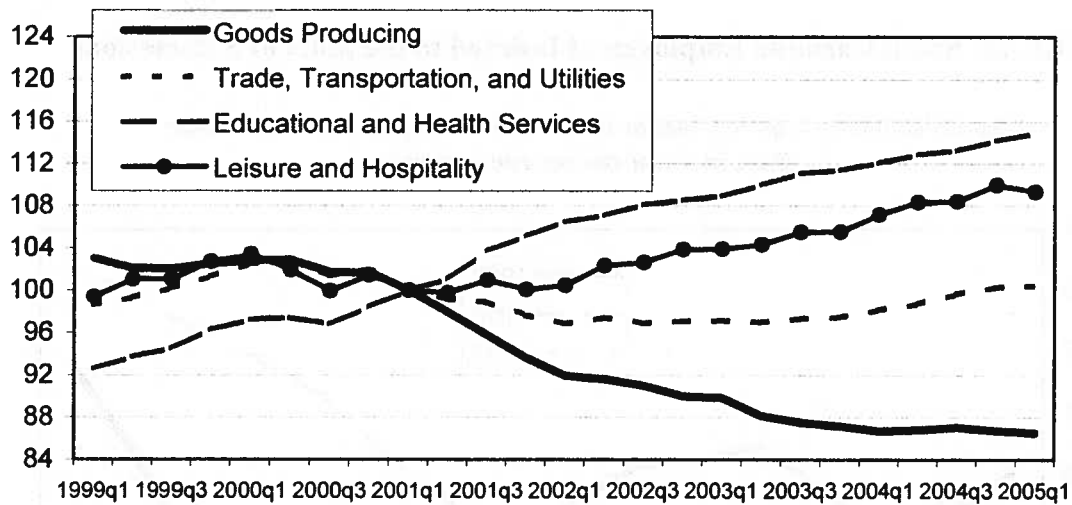
Special Risks for South Carolina

The Palmetto Institute was interested in understanding whether South Carolina's economy is particularly at risk because of the importance of its tourism industry. Figures 19 and 20 below show the performance of selected industries in South Carolina over the last two recessions – a period for which industry-specific data are available. As is clear, the leisure and hospitality industries, like many service industries, have been relatively more stable during recessions than manufacturing industries that traditionally are hit hard

by recessions. In both recessions employment in leisure and hospitality declined slightly before resuming its rise, and declined by far less than did employment in goods-producing and trade and transportation industries. However, the leisure and hospitality industries include activity spurred by local consumption as well as by tourism, and so these graphs may understate the risk to South Carolina of a broad economic slowdown that reduces tourism.

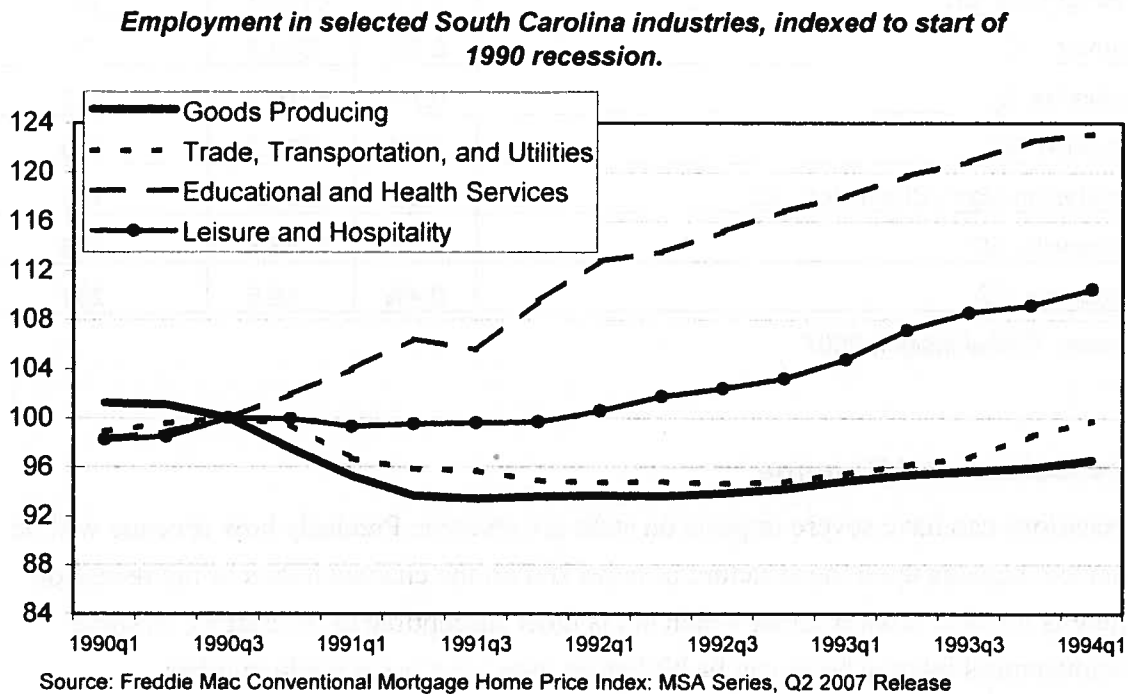
FIGURE 19: South Carolina 2001 Recession Employment

South Carolina was hit harder in the 1980 "double dip" recession than in other recent recessions.



Source: Freddie Mac Conventional Mortgage Home Price Index: MSA Series, Q2 2007 Release

FIGURE 20: South Carolina 1990 Recession Employment



Another issue in South Carolina is its susceptibility to the subprime mortgage crisis. According to the Mortgage Bankers Association, South Carolina has a greater share of subprime adjustable-rate mortgage loans in serious delinquency than the national average. Furthermore, a recent analysis by Global Insight, an economic consulting firm, concluded that the Myrtle Beach metropolitan area was likely to suffer the greatest loss in growth of domestic product in the nation as a result of the subprime mortgage crisis, and that several other South Carolina metropolitan areas are likely to suffer significant slowdowns as well, with Spartanburg and Sumter in the top 25 percent of hardest-hit metropolitan areas (Table 14).

TABLE 14: Estimates of Loss in Gross Metropolitan Product Growth Due to Subprime Mortgage Crisis

Metropolitan Area	Loss in Real GMP Growth	Loss of GMP, Millions	Rank out of 361 Metropolitan areas (1=hardest hit)

Myrtle Beach-Conway-North Myrtle Beach, SC	1.7%	\$243.1	1
Spartanburg, SC	1.1%	\$176.8	20
Sumter, SC	0.9%	\$53.3	71
Columbia, SC	0.7%	\$275.1	122
Florence, SC	0.6%	\$34.3	159
Charleston-North Charleston, SC	0.5%	\$122.2	196
Greenville, SC	0.5%	\$153.8	196
Anderson, SC	0.4%	\$8.5	231

Source: Global Insight, 2007

Recessions and Revenue

Recessions can have severe impacts on state tax revenue. Precisely how revenue will be affected depends upon the structure of taxes and on the characteristics of the recession. There is no clear answer about which tax is most susceptible to recessions. In some circumstances income taxes can be hit harder than sales taxes while in other circumstances the opposite is true.

In addition, the characteristics of individual taxes affect the responsive of taxes.³² For example a broad-based sales tax that includes food will be more stable than a narrower based sales tax, because people's purchases of food do not drop off as much during a recession as do their purchases of other more discretionary items. Progressive income taxes can also be much more volatile than those that are flatter in part because the incomes of upper income individuals often are more variable than those of lower income people. For example, capital gains income, interest income and dividend income, which are disproportionately received by upper income people, tend to fall off more rapidly than wage income during a recession.

Although it is not always clear which tax is most volatile, in general, states that rely on a portfolio of different taxes are likely to have less volatility than states that rely heavily on a single tax. Revenue from individual taxes generally does not move in lockstep with revenue from other taxes, and so much as a portfolio of different securities will be less volatile than individual securities, a portfolio of taxes also will be less volatile.

³² See Bruce, Fox, and Tuttle 2006 for analysis of many of these issues.

Finally, revenue from individual taxes may respond differently on the upside than when the economy is moving down and may respond differently when tax revenue is above its long-term trend than when it is below. Bruce, Fox, and Tuttle analyzed this issue in a 2006 article for the *Southern Economic Journal*, producing state-by-state estimates of income tax and sales tax responsiveness to economic changes under different circumstances. Their estimates suggest that South Carolina's sales tax and income tax both would return relatively rapidly to their long-run equilibrium when they start out above that equilibrium, as often would be the case prior to a recession. Put differently, their estimates suggest that South Carolina's tax revenue could decline rapidly when the economy does.

Figure 21 below shows annual percentage changes in state government tax revenue in South Carolina and for the U.S. as a whole, adjusted for inflation and population growth. South Carolina's revenue performed worse than the national average in the 1990-91 recession but very similarly to the nation in the 1980 and 2001 recessions. The figure also shows that revenue declined far more sharply in the 2001 recession than it did in the earlier recessions, which seems at odds with the earlier analysis showing that the most recent recession was in fact less severe. In fact, state government nominal tax revenue for the 50 states as a whole declined for two consecutive years during this period, the first time in at least 50 years that this has occurred. For South Carolina, real per capita tax revenue fell by only 2.7 percent from peak to trough in the 1980-82 recession (reflecting multiple years of declines), by 8.5 percent in the 1990-91 recession, and by 10.4 percent in the 2001 recession. These data suggest that tax revenue may be increasingly volatile, while the economy is less volatile.

FIGURE 21: State Government Tax Revenue in South Carolina and Sum of States, Adjusted for Inflation and Population Growth

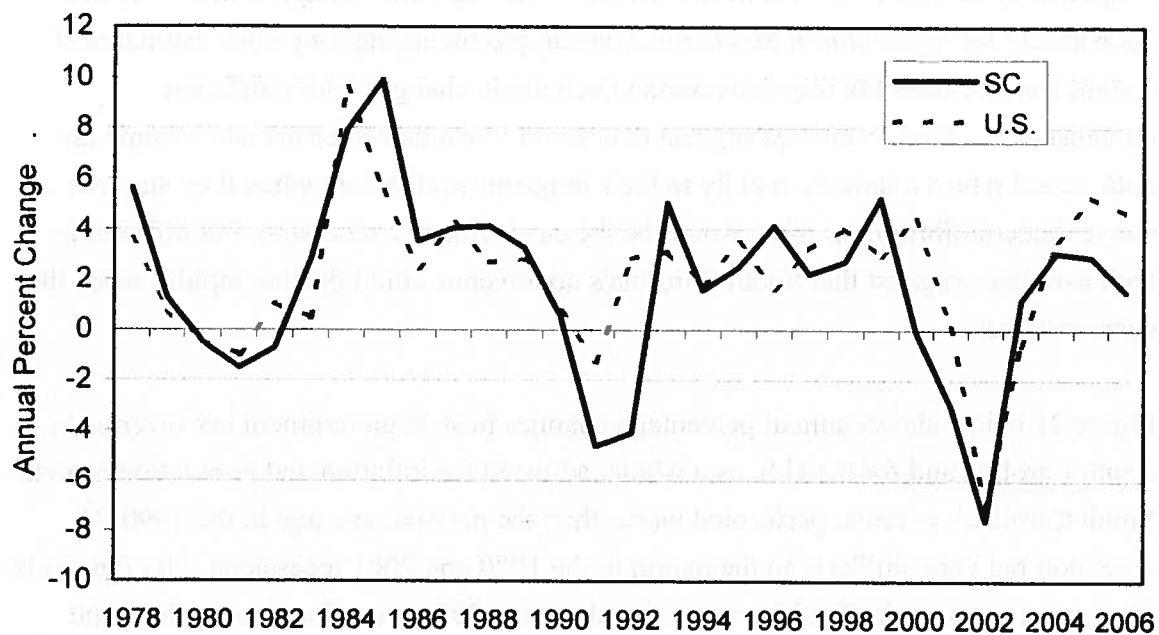
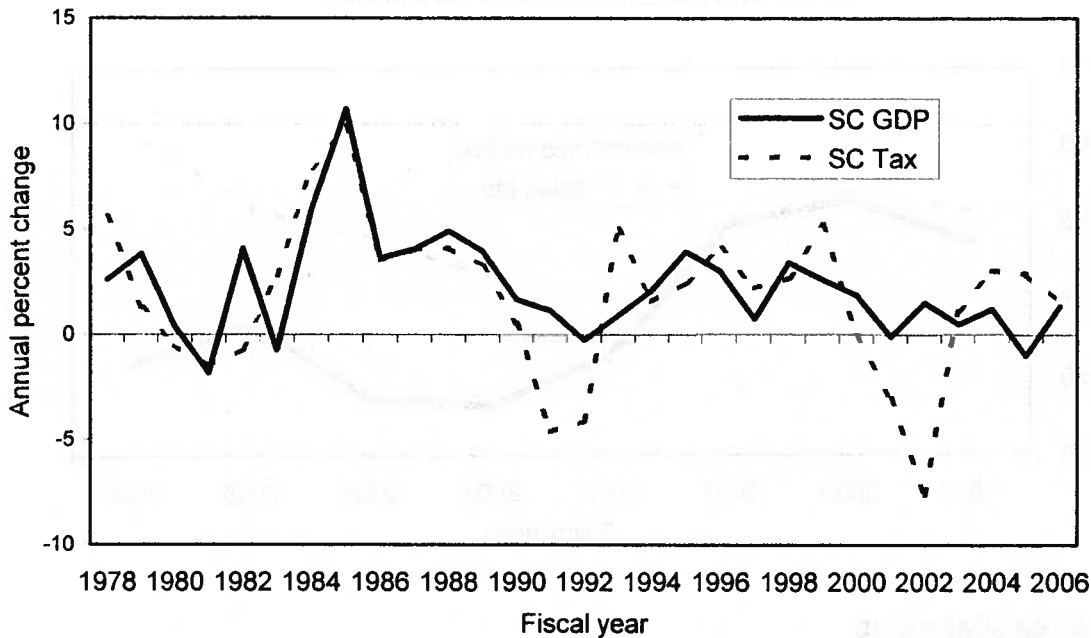


Figure 22 shows the percentage change in real per capita tax revenue and in real per capita gross domestic product in South Carolina. Again we see that the 2001 recession is especially notable because tax revenue fell so much more sharply than the change in gross domestic product might suggest. Why did tax revenue fall so much more sharply than the economy?

FIGURE 22: South Carolina Real GDP Per Capita and Real Taxes Per Capita

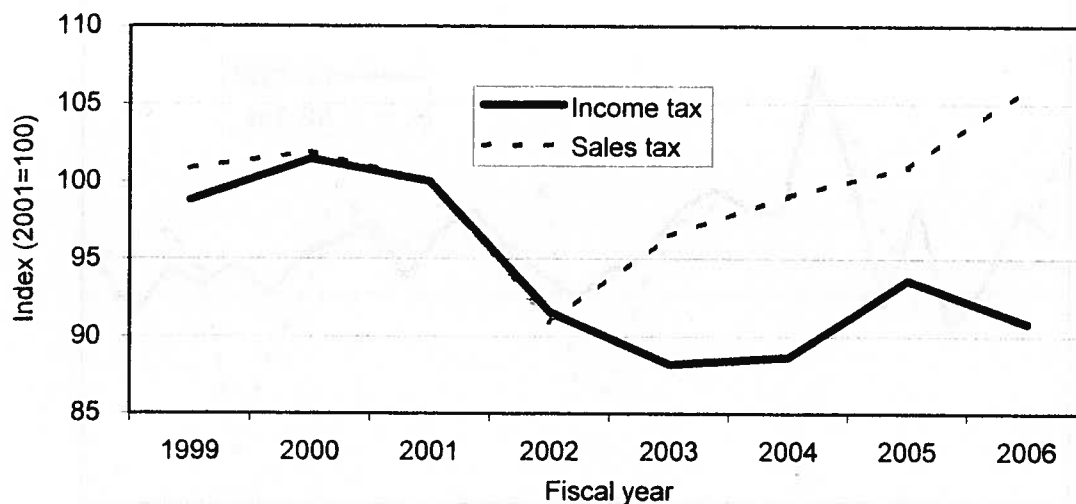
South Carolina's tax revenue decline in 2001 recession was dramatic and far worse than the economy would have suggested.



If we look at individual taxes, we see that the income tax fell more sharply than did the sales tax and for a longer period of time. Figure 23 below shows real per capita income and sales taxes in South Carolina indexed to the 2001 fiscal year. Both fell nearly 10 percent in 2002 in real per capita terms. After that, the sales tax began to recover, but the income tax fell sharply for a second year and then grew only slightly in the year after that. This recession was particularly damaging to the income tax. Why is it that a relatively mild recession had such a severe impact on the income tax?

FIGURE 23: South Carolina Income and Sales Tax, 2001 Recession, Adjusted for Inflation and Population Growth, Indexed to 2001

South Carolina's sharp falloff in revenue in the 2001 recession was driven by a persistent income tax decline.



Role of capital gains

One reason the income tax fell so sharply in South Carolina and in other states in the 2001 recession is that capital gains, which had grown enormously prior to the recession, fell sharply as stock markets plummeted. Over the 50-year period for which we have data on capital gains, they averaged approximately 2.6 percent of gross domestic product for the nation as a whole. However, as a result of the stock market boom of the 1990s capital gains rose to 6.6 percent of gross domestic product by 2000.³³ Over the next two years capital gains fell by more than 60 percent, with devastating impacts on budgets of states that rely heavily on tax revenue from capital gains.

Special factors contributed to the sharp falloff in capital gains. First, of course, there was a dramatic run-up in the stock market that ended in early 2000, driven by the tech stock frenzy. Second, the increasing use of stock options as a form of compensation combined with the market rise created opportunities for executives, managers, and others to cash in extraordinary gains. Finally, capital gains subject to tax are not the gains that *accrue* from year to year, but the gains that taxpayers *realize* – gains that they generally choose to

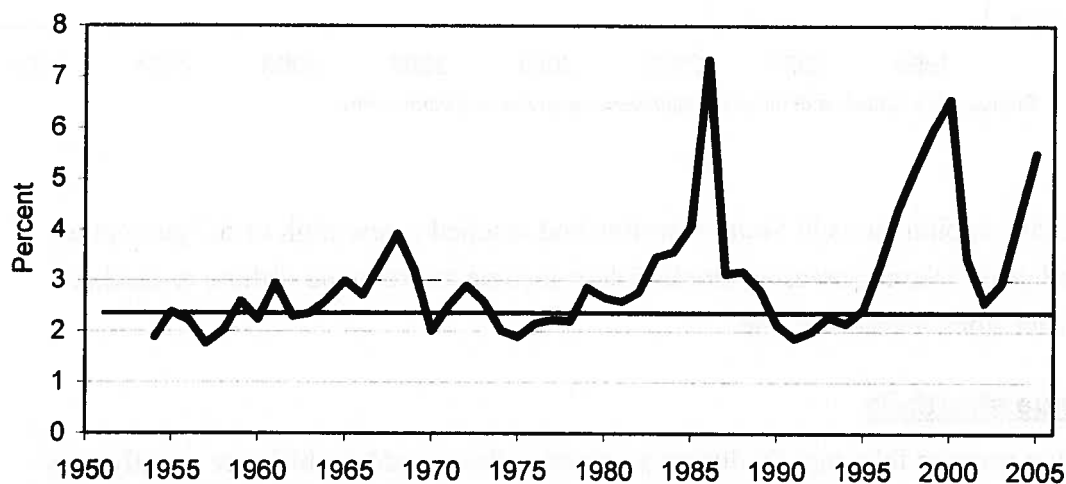
³³ This does not count the spike in 1986, when capital gains rose to 7.3% of GDP, reflecting the behavioral response of taxpayers to an impending increase in the tax rate on capital gains.

take, for example by selling stock. Fears of an overblown market and of losing the last opportunities to take gains likely contributed to the late-1990s increase in gains, and the subsequent dearth of capital gains.

In the subsequent stock market recovery, capital gains rebounded sharply and by 2005 they had reached 5.5 percent of GDP, almost back to their pre-recession peak. Figure 24 shows capital gains as a percentage of gross domestic product over the last 50-plus years. It is clear just how unusual the peak was in 2000, and how unusual it is now. While there are sound reasons why capital gains might now be above the long-term trends, related to economy, tax rates, and other aspects of the tax system, states once again appear to face substantial budget risk if the stock market plummets.

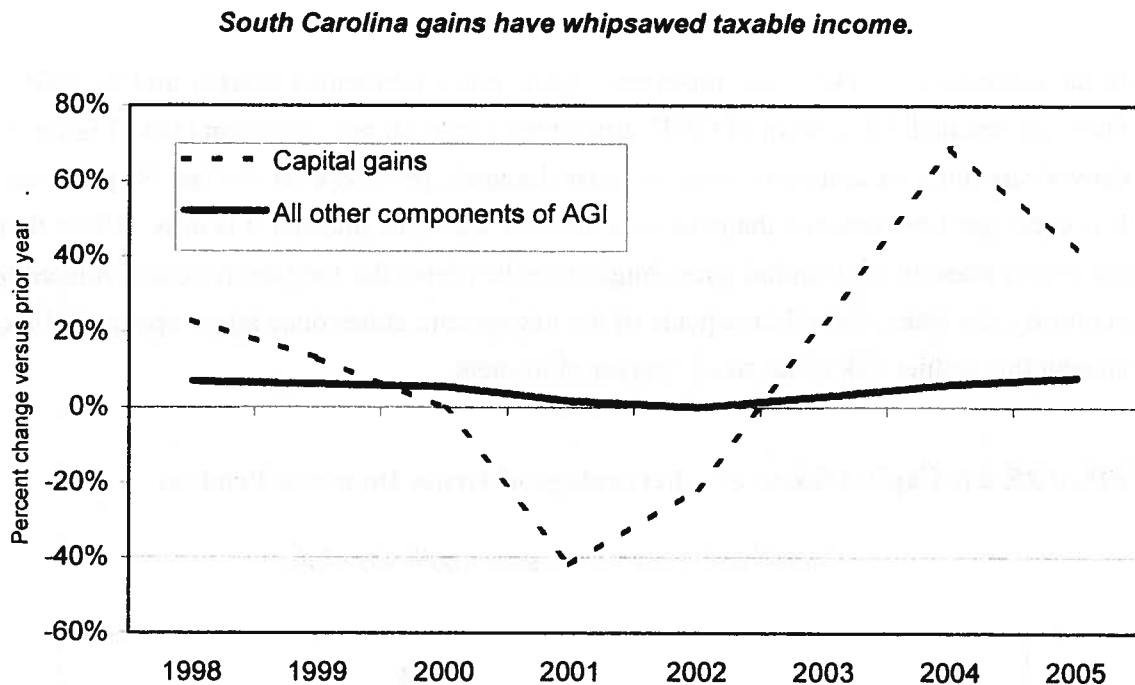
FIGURE 24: Capital Gains as a Percentage of Gross Domestic Product

Capital gains are once again atypically high.



South Carolina has been both helped and hurt by volatile capital gains. Figure 25 shows the growth rates of capital gains compared with all other components of adjusted gross income in South Carolina over the last eight years for which there are data. It is clear that gains are far more volatile than other income and contributed to the decline in South Carolina's income tax in the 2001 recession. In fact, between 1999 and 2002 capital gains in South Carolina fell by 54 percent. As in the nation as a whole, capital gains in South Carolina have again risen sharply - increasing by 195 percent between 2002 and 2005.

FIGURE 25: Capital Gains and Other Components of South Carolina Adjusted Gross Income, Percent Change Versus Prior Year



Source: IRS Statistics of Income, <http://www.irs.gov/taxstats/index.html>

As of 2005, capital gains in South Carolina had reached a new high of 6.7 percent of adjusted gross income, creating ample risk to income tax revenue if there is another significant stock market decline.

Revenue shortfalls

When tax revenue falls rapidly during a recession these sudden shifts are usually very difficult to predict, especially when driven by hard to predict changes such as a 60 percent reduction in capital gains. As a result during recessions states often have large revenue shortfalls compared with the budgetary projections, leading to unanticipated cuts in spending, possible tax increases, reserve fund drawdowns, and other unpleasant actions. Table 15 below shows the revenue shortfalls in South Carolina during each of the last two recessions compared with original budget projections, as reported by the National Governors Association and the National Association of State Budget Officers. The cumulative shortfall was larger in the 2001 recession than in the 1990 recession, consistent with the analysis above, and the income tax shortfalls were larger than the sales tax shortfalls. (Corporate tax shortfalls were the largest by far, in percentage terms,

but fortunately from a forecasting standpoint, South Carolina does not rely heavily on corporate income taxes.)

TABLE 15: South Carolina Revenue Shortfalls for Major Taxes, 2 Recession Periods

<i>Revenue shortfalls in each of last 2 recessions were huge - and twice as large in most recent recession as in 1990+ recession.</i>				
Year	Sales Tax	Income Tax	Corporate Tax	Sum of Major Taxes
1990	1.8%	1.2%	-32.2%	-1.5%
1991	-4.1%	-8.3%	-30.9%	-8.2%
1992	-5.0%	-8.3%	-10.8%	-7.0%
<i>Cumulative Shortfall (compounded)</i>	-7.4%	-14.8%	-58.2%	-15.9%
2001	-4.4%	-6.9%	-9.5%	-5.9%
2002	-6.9%	-18.4%	-37.3%	-13.8%
2003	-5.8%	-19.4%	-39.9%	-13.8%
<i>Cumulative Shortfall (compounded)</i>	-16.2%	-38.8%	-65.9%	-30.1%

Source: NASBO/NGS Fiscal Survey of the States, Fall of relevant year.

How Hard Will the Next Recession Hit South Carolina Finances?

The BEA analysis projects what could happen if the next recession is similar in character to the 2001 recession. By traditional measures the economic impact of that recession was mild, but it triggered the worst revenue declines for states in more than 50 years. South Carolina's economy was hit a little bit harder than the nation's as a whole, but not by much. Along with other states, South Carolina suffered severe tax revenue declines: real per-capita state tax revenue declined by 10.4 percent despite almost no decline in output, and, according to the National Association of State Budget Officers, taxes fell short of projections for three years running with double-digit shortfalls in two of those years.

Income taxes accounted for a disproportionate share of tax revenue declines and shortfalls.

The income tax declined so significantly in part because the 2001 recession had very special features – three consecutive years of stock market declines, a 60 percent falloff in capital gains, and sharp declines in other forms of nonwage income. The BEA scenario assumes this could happen again. This is probably too pessimistic. While it is true that South Carolina capital gains are now a larger share of adjusted gross income than they were prior to the start of the last recession, three consecutive declines in the stock market of the magnitude seen in the early 2000's seems unlikely. With that said, there is extraordinary market volatility this year – the market declined sharply in November from its peak, prior to a late-month recovery. Revenue forecasters are right to be cautious.

And the next recession could certainly be deeper than the 2001 recession, especially in South Carolina. According to Global Insight, the Myrtle Beach MSA is likely to slow the most as a result of the subprime mortgage crisis, and other fast-growing areas could be similarly hampered. South Carolina faces special risks in this economic environment.

The current slowdown may affect the sales tax more than the income tax, and this is supported by state tax collections so far during this fiscal year. The current downturn is linked more to a housing bust rather than the investment/capital gains bust of 2001. Sales tax revenues may weaken as the sales of building materials and furnishings linked to new housing slacken. Then, consumers may lower their purchases of other goods, as they are discouraged about housing prices and the economy more generally. Thus, consumption will flatten out, or potentially could decrease during the current slowdown. So, even if capital gains do not fall as radically as during 2001, tax revenues could weaken as much.

Even if revenue does not decline by a cumulative 10.4 percent as in 2001, the alternatives are not attractive. Real per capita tax revenue declined by 8.5 percent in the 1990-91 recession. While that may be better, it is not a lot better. And an even milder recession still would be likely to have fiscal impacts that are very disruptive to the services and programs provided by the state of South Carolina.

Ultimately, we think it is unlikely that tax revenue will decline as sharply during the next two years as in the 2001 recession, unless the recession itself is far more severe. However, we agree with the overall point of the BEA analysis – even a modest recession

or significant economic slowdown could lead to large unanticipated shortfalls in revenue, and to large and unpleasant shifts in policy, even if the revenue decline is not as significant as in 2001. Recent reports suggest that tax collections have been weakening in most parts of the country, and South Carolina has been no exception with revenue shortfalls in its current budget recently projected by the Board of Economic Advisors.³⁴

³⁴ See Boyd, 2008; Dadayan and Ward, 2008; and Associated Press, April 8, 2008.

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